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DEPOSITORY AND LENDING INSTITUTIONS *With Conforming Changes as of May 1, 2007* AICPA®

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Guide

DEPOSITORY AND LENDING INSTITUTIONS

Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies

WITH CONFORMING CHANGES
AS OF MAY 1, 2007

AICPA®

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AICPA Audit and Accounting Guide

DEPOSITORY AND LENDING INSTITUTIONS

Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies

American Institute of Certified Public Accountants

WITH CONFORMING CHANGES AS OF MAY 1, 2007

AICPA

This edition of the AICPA Audit and Accounting Guide *Depository and Lending Institutions Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*, which was originally issued in 2004, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued. The changes made for the current year are identified in a schedule in Appendix F of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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Notice to Readers

This AICPA Audit and Accounting Guide has been prepared by the AICPA Financial Institution Guide Combination Task Force to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board (FASB) as sources of accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the FASB. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

This AICPA Audit and Accounting Guide, which contains auditing guidance, is an interpretive publication pursuant to AU section 150 (AICPA, *Professional Standards*, vol. 1), *Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this Guide to be consistent with existing SASs.

An auditor should be aware of and consider interpretive publications applicable to his or her audit. Interpretative publications are not as authoritative as a pronouncement of the ASB however, if an auditor does not apply the auditing guidance included in an applicable Audit and Accounting Guide, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance. The specific terms used to define professional requirements in the SASs are not intended to apply to interpretive publications since interpretive publications are not auditing standards. It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists.*

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* In December 2005, the Auditing Standards Board (ASB) issued SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards*, and the companion Statement for Attestation Engagements (SSAE) 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*. Those statements, which were effective upon issuance, define the terminology that the ASB will use going forward to describe the degree of responsibility that the requirements impose on the auditor or the practitioner in engagements performed for nonissuers. SASs and SSAEs

(continued)

Public Accounting Firms Registered With the PCAOB

Subject to the Securities and Exchange Commission (Commission) oversight, Section 103 of the Sarbanes-Oxley Act (Act) authorizes the Public Company Accounting Oversight Board (PCAOB) to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the Commission. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers, as defined by the Act, and other entities when prescribed by the rules of the Commission.

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The AICPA gratefully acknowledges the following individuals for their assistance in the review of the conforming changes for the May 2007 edition of this Guide:

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Keith Newton
Sydney K. Garmong
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Myrna Parker

(footnote continued)

will use the words "must" or "is required" to indicate an *unconditional requirement*, with which the auditor or practitioner is required to comply. SASs and SSAEs will use the word "should" to indicate a presumptively mandatory requirement. The auditor or practitioner is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the auditor or practitioner may depart from a presumptively mandatory requirement provided the auditor or practitioner documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. If a SAS or SSAE provides that a procedure or action is one that the auditor "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

The AICPA would also like to thank and acknowledge Judith Sherinsky for her contribution to this Guide.

This Guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the Guide was originally issued. Relevant guidance contained in official pronouncements issued through May 1, 2007 have been considered in the development of this edition of the Guide. This includes relevant guidance issued up to and including the following:

- FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*
- FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB Staff Positions issued through May 1, 2007
- FASB Emerging Issues Task Force (EITF) consensus positions adopted at meetings of the EITF held through May 1, 2007
- Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*
- SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)
- SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*
- SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50)
- PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards")

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

The changes made for this current year are identified in a schedule in Appendix F of this Guide. The changes do not include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

Preface

This American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide has been prepared to assist financial institutions in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent accountants in reporting on financial statements (and, as discussed in Appendix A, other written management assertions) of those entities.

Chapters of the Guide are generally organized by financial statement line item into four sections:

a. An *Introduction* that describes the general transactions and risks associated with the area. (The introduction does not address all possible transactions in each area.)

b. *Regulatory Matters* that may be of relevance in the preparation and audit of financial statements. Other regulatory matters may exist that require attention in the preparation and audit of financial statements following the general guidance on regulatory matters. Further, the Guide does not address regulations that are not relevant to the preparation and audit of financial statements and certain of the regulatory requirements discussed may not be applicable to uninsured institutions.

c. *Accounting and Financial Reporting* guidance that addresses accounting and financial reporting issues (Statement on Auditing Standards [SAS] No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles [AICPA, *Professional Standards*, vol. 1, AU sec. 411], establishes the hierarchy of GAAP).[1]

d. *Auditing* guidance that includes objectives, planning, internal control over financial reporting and possible tests of controls, and substantive tests.

Applicability

Scope

Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guides *Banks and Savings Institutions* (BSI Guide), *Audits of Credit Unions* (CU Guide), and *Audits of Finance Companies* (FC Guide). SOP 01-6 was issued on December

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[1] Footnote 3 to SAS No. 69 states, in part, that, for Securities and Exchange Commission (SEC) registrants, rules and releases of the SEC have an authority similar to other officially established accounting principles. For example, Article 9 of Regulation S-X specifies the form and content of and requirements for financial statements filed with the SEC by bank holding companies. Similarly, bank holding companies disclose supplemental statistical disclosures in filings following the guidance of Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*. SEC Staff Accounting Bulletin (SAB) No. 69, *Application of Article 9*, includes the SEC staff view that Article 9 and Industry Guide 3, "while applying literally only to bank holding companies, provide useful guidance to certain other SEC registrants, including savings and loan holding companies, on certain disclosures relevant to an understanding of the registrant's operations." Those rules and interpretive releases, including SEC SABs, are not presented in the Guide; however, readers should consult the applicable requirements as necessary.

26, 2001 and was effective for annual and interim financial statements issued for fiscal years beginning after December 15, 2001.

Consistent with the scope of SOP 01-6, this Guide applies to all banks, savings institutions, credit unions, finance companies, and other entities (including entities with trade receivables) subject to the May 1, 2000 AICPA Audit and Accounting Guides: BSI Guide, CU Guide, and FC Guide, respectively. That population includes the following:

a. Finance companies, including finance company subsidiaries

b. Entities that do not consider themselves to be finance companies that engage in transactions that involve lending to or financing the activities of others (including trade receivables and independent and captive financing activities of all kinds of entities[2])

c. Depository institutions insured by the Federal Deposit Insurance Corporation's (FDIC's) Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF), or the National Credit Union Administration's (NCUA's) National Credit Union Share Insurance Fund (NCUSIF)

d. Bank holding companies

e. Savings and loan association holding companies

f. Branches and agencies of foreign banks regulated by U.S. federal banking regulatory agencies

g. State-chartered banks, credit unions, and savings institutions that are not federally insured

h. Foreign financial institutions whose financial statements are purported to be prepared in conformity with accounting principles generally accepted in the United States

i. Mortgage companies

j. Entities that do not consider themselves to be mortgage companies that engage in transactions that involve mortgage activities or transactions

k. Corporate credit unions

l. Financing and lending activities of insurance companies

Consistent with the scope of SOP 01-6, this Guide does not apply to the following:

a. Investment companies, broker-dealers in securities, employee benefit plans and similar entities that carry loans and trade receivables at fair value with the unrealized gains and losses included in earnings

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[2] The term *enterprises* is used in practice as business enterprises organized for profit. To the extent that a not-for-profit organization, as defined in Appendix D of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*, conducts activities in the scope of paragraph 3, provisions of SOP 01-6 should be applied. The AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, provides such guidance in Chapter 1, Appendix D [paragraph 1.27] as follows: "However, some not-for-profit organizations conduct activities in some of those industries and should apply the guidance concerning recognition and measurement of assets, liabilities, revenues, expenses, gains and losses in those pronouncements to the transactions unique to those industries."

b. Governmental or federal entities that follow the principles of the Governmental Accounting Standards Board (GASB) or the Federal Accounting Standards Advisory Board (FASAB)

c. Financing and lending transactions that are subject to category *a* of generally accepted accounting principles (GAAP) in the hierarchy established by SAS No. 69 if the category *a* guidance differs from the guidance in SOP 01-6

Conforming changes have been made to this Guide to reflect accounting and auditing pronouncements and regulatory requirements issued since the May 1, 2000 editions of the AICPA Audit and Accounting Guides: BSI Guide, CU Guide, and FC Guide.

As used in this Guide, the term *depository institutions* means banks, credit unions, and savings institutions. The terms *financial institutions* or *institutions* refer to all entities covered by this Guide. The table at the end of this Preface shows how individual chapters apply to the entities covered by this Guide.

As stated above, this Guide applies to the financing activities of all kinds of enterprises. Certain entities may have financing activities but are not otherwise covered by this Guide—for example, the financing subsidiary, unit, or division of a manufacturing company or retailer. Only those sections and chapters of this Guide related to financing activities are intended to apply to such entities. The remaining portions are not intended to apply to such entities, but may otherwise be useful to financial statement preparers and auditors.

Certain terms are used interchangeably throughout the Guide as follows:

- Credit unions often refer to **shares, dividends on shares, and members**, which are equivalent to **deposits, interest on deposits, and customers** for banks and savings institutions.
- Finance companies often refer to **finance receivables**, which are equivalent to **loans** or **loans receivable** for other entities. A **credit officer** of a finance company is the same as a **loan officer**.
- A **supervisory committee** of a credit union is the functional equivalent of an **audit committee** of other entities.

Limitations

The Guide is intended to highlight significant matters and establish general guidance. It is not intended to provide a comprehensive discussion of all possible matters of significance in the preparation of financial statements of a financial institution or all situations that an independent accountant might encounter in an audit of the financial statements of a financial institution.

Consulting the accounting and financial reporting and auditing sections of the Guide cannot take the place of a careful reading of specified authoritative literature. Other professional literature and authoritative guidance that may be issued by the Accounting Standards Executive Committee (AcSEC), the Financial Accounting Standards Board (FASB), including its Emerging Issues Task Force (EITF), the Auditing Standards Board (ASB), or the Public Company Accounting Oversight Board (PCAOB) may affect audits of the financial statements of financial institutions. Further, the nature, timing, and extent of audit procedures applied in a financial statement audit is ultimately determined by the independent accountant in the circumstances. The procedures discussed in the auditing section of the Guide are not intended to be comprehensive and, performed by themselves, would not necessarily constitute an audit in accordance with generally accepted auditing standards (GAAS) or in accordance with the standards of the PCAOB. Nor would omission of certain procedures set forth in the Guide necessarily result in a violation of GAAS or the standards of the PCAOB. Internal control over financial reporting and possible tests of controls are discussed in the context of a financial statement audit. While they may correspond to internal controls that are the subject of procedures performed in an engagement performed in accordance with SSAEs, internal control over financial reporting and possible tests of controls are not presented in that context and are not intended to address the considerations of such an engagement.

Impact on Other Literature

This Guide supersedes the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*.

Auditing Guidance Included in This Guide

In March 2006, the ASB issued Statements on Auditing Standards Nos. 104-111 (the "risk assessment standards"). Collectively, the risk assessment standards establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by fraud or error) in a nonissuer financial statement audit; design and performance of tailored audit procedures to address assessed risks; audit risk and materiality; planning and supervision; and audit evidence. The most significant changes to existing practice that the auditor will be required to perform are as follows:

- Obtain a more in-depth understanding of the audited entity and its environment, including its internal control;
- Perform a more rigorous assessment of the risks of where and how the financial statements could be materially misstated (defaulting to a maximum control risk is no longer permitted);
- Provide a linkage between the auditor's assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The statements are effective for audits of financial statements for periods beginning on or after December 15, 2006. Early adoption is permitted. See Appendix E for a more detailed comparison between the risk assessment standards and the existing standards.

This guide has been conformed to the new risk assessment standards to indicate, at a minimum, where these standards need to be applied. Additional implementation guidance, specific to this industry, is being developed and will be incorporated in the 2008 edition.

For additional guidance on the risk assessment standards, please refer the AICPA Audit Guide, *Assessing and Responding to Risk in a Financial Statement Audit*, and the AICPA Audit Risk Alert, *Understanding the New Auditing Standards Related to Risk Assessment*.

References to Professional Standards

In citing the professional standards, references are made to the AICPA *Professional Standards* publication. In those sections of the guide where specific PCAOB auditing standards are referred to, references are made to the AICPA's *PCAOB Standards and Related Rules* publication. Please refer to Appendix D of this Guide for a summary of major existing differences between AICPA Standards and PCAOB Standards. Additionally, when referencing professional standards, this Guide cites section numbers and not the original statement number, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54 is referred to as AU section 317.

Applicability of Requirements of the Sarbanes-Oxley Act of 2002, Related Securities and Exchange Commission Regulations, and Standards of the Public Company Accounting Oversight Board

Publicly-held companies and other "issuers" (see definition below) are subject to the provisions of the Sarbanes-Oxley Act of 2002 (Act) and related Securities and Exchange Commission (SEC) regulations implementing the Act. Their outside auditors are also subject to the provisions of the Act and to the rules and standards issued by the Public Company Accounting Oversight Board (PCAOB).

Presented below is a summary of certain key areas addressed by the Act, the SEC, and the PCAOB that are particularly relevant to the preparation and issuance of an issuer's financial statements and the preparation and issuance of an audit report on those financial statements. However, the provisions of the Act, the regulations of the SEC, and the rules and standards of the PCAOB are numerous and are not all addressed in this section or in this Guide. Issuers and their auditors should understand the provisions of the Act, the SEC regulations implementing the Act, and the rules and standards of the PCAOB, as applicable to their circumstances.

> *Definition of an Issuer*
>
> The Act states that the term *issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.
>
> Issuers, as defined by the Act, and other entities when prescribed by the rules of the SEC (collectively referred to in this Guide as "issuers" or "issuer") and their public accounting firms (who must be registered with the PCAOB) are subject to the provisions of the Act, implementing SEC regulations, and the rules and standards of the PCAOB, as appropriate.
>
> Nonissuers are those entities not subject to the Act or the rules of the SEC.

Guidance for Issuers†

Management Assessment of Internal Control

As directed by Section 404 of the Act, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies and certain other entities (for example, 11-K filers), to include in their annual reports a report of management on the company's internal control over financial reporting. See the SEC Web site at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation.

Companies that are "accelerated filers," as defined in Exchange Act Rule 12b-2, are required to comply with these rules for fiscal years ending on or after November 15, 2004. Foreign private issuers that are accelerated filers and that file their annual reports on Form 20-F or 40-F must begin to comply with rules for the first fiscal year ending on or after July 15, 2006. "Nonaccelerated filers" and foreign private issuers that are not accelerated filers must begin to comply with the rules for the first fiscal year ending on or after July 15, 2007. See the SEC Web site at www.sec.gov/rules/final/33-8545.htm for further information.

The SEC rules clarify that management's assessment and report is limited to internal control over financial reporting. The SEC's definition of internal control encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Under the SEC rules, the company's annual 10-K must include:

1. Management's Annual Report on Internal Control Over Financial Reporting
2. Attestation Report of the Registered Public Accounting Firm
3. Changes in Internal Control Over Financial Reporting

The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially

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† On May 23, 2007 the SEC approved new interpretive guidance designed to help management of public companies strengthen internal control over financial reporting and enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002. The guidance, previously proposed as Release No. 33-8762, Management's Report on Internal Control Over Financial Reporting, provides, among other significant provisions, interpretive guidance for management regarding their evaluations of internal control over financial reporting and clarification regarding the auditor's reporting requirements pursuant to Section 404(b) of the Sarbanes-Oxley Act. Under the guidance, management can align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting. The SEC also approved rule amendments providing that a company that performs an evaluation in accordance with the new interpretive guidance also satisfies the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15. Among other rule changes, the SEC also re-defined the term "material weakness" and revised the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to require the auditor to express an opinion directly on the effectiveness of internal control over financial reporting and not on management's evaluation process. Readers should refer to the SEC Web site at www.sec.gov for more information. On May 24, 2007, the PCAOB adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, to replace Auditing Standard No. 2. Once the new standard is approved by the SEC, it will be effective for all audits of internal control for fiscal years ending on or after November 15, 2007. Earlier application will be permitted. Auditing Standard No. 5 is principles-based. It is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. The final standard also focuses the auditor on the procedures necessary to perform a high quality audit that is tailored to the company's facts and circumstances. Readers should refer to the PCAOB Web site at www.pcaob.org for more information.

affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

Audit Committees and Corporate Governance

Section 301 of the Act establishes requirements related to the makeup and the responsibilities of an issuer's audit committee. Among those requirements—

- Each member of the audit committee must be a member of the board of directors of the issuer, and otherwise be independent.
- The audit committee of an issuer is directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.
- The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

In April 2003, the SEC adopted a rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

Disclosure of Audit Committee Financial Expert and Code of Ethics

In January 2003, the SEC adopted amendments requiring issuers, other than registered investment companies, to include two new types of disclosures in their annual reports filed pursuant to the Securities Exchange Act of 1934. These amendments conform to Sections 406 and 407 of the Act and relate to disclosures concerning the audit committee's financial expert and code of ethics relating to the companies' officers. An amendment specifies that these disclosures are only required for annual reports.

Certification of Disclosure in an Issuer's Quarterly and Annual Reports

Section 302 of the Act requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of each issuer to prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." In August 2002, the SEC adopted final rules for Certification of Disclosure in Companies' Quarterly and Annual Reports in response to Section 302 of the Act. CEOs and CFOs are now required to certify the financial and other information contained in quarterly and annual reports.

Improper Influence on Conduct of Audits

Section 303 of the Act makes it unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading. In April 2003, the SEC adopted rules implementing these provisions of the Act.

Disclosures in Periodic Reports

Section 401(a) of the Act requires that each financial report of an issuer that is required to be prepared in accordance with generally accepted accounting principles (GAAP) shall "reflect all material correcting adjustments . . . that have been identified by a registered accounting firm . . . ." In addition, "each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions" and "other relationships" with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

In January 2003, the SEC adopted rules that require disclosure of material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. The rules require an issuer to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis section of an issuer's disclosure documents.

Guidance for Auditors

The Act mandates a number of requirements concerning auditors of issuers, including mandatory registration with the PCAOB, the setting of auditing standards, inspections, investigations, disciplinary proceedings, prohibited activities, partner rotation, and reports to audit committees, among others. Auditors of issuers should familiarize themselves with applicable provisions of the Act and the standards of the PCAOB. The PCAOB continues to establish rules and standards implementing provisions of the Act concerning the auditors of issuers.

Applicability of Generally Accepted Auditing Standards and Public Company Accounting Oversight Board Standards

The Act authorizes the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports for entities subject to the Act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of "issuers," as defined by the Act, and other entities when prescribed by the rules of the SEC.

For those entities not subject to the Act or the rules of the SEC, the preparation and issuance of audit reports remain governed by GAAS as issued by the ASB.

Major Existing Differences Between GAAS and PCAOB Standards

Major differences between GAAS and PCAOB Standards are described in both Part I of volume one of the AICPA *Professional Standards* and in Part I of the AICPA publication titled, *PCAOB Standards and Related Rules*. Please refer to Appendix D of this Guide for a summary of major existing differences between AICPA Standards and PCAOB Standards.

Auditor Reports to Audit Committees

Section 204 of the Act requires the accounting firm to report to the issuer's audit committee all "critical accounting policies and practices to be used . . . all alternative treatments of financial information within [GAAP] that have been discussed with management . . . ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Sarbanes-Oxley Requirements

The Act contains requirements in a number of other important areas, and the SEC has issued implementing regulations in certain of those areas as well. For example:

- The Act prohibits auditors from performing certain nonaudit or nonattest services. The SEC adopted amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the SEC. This rule conforms the SEC's regulations to Section 208(a) of the Act and, importantly, addresses the performance of nonaudit services.
- The Act requires the lead audit or coordinating partner and the reviewing partner to rotate off of the audit every 5 years. (See SEC Releases 33-8183 and 33-8183A for SEC implementing rules.)
- The Act directs the PCAOB to require a second partner review and approval of audit reports (concurring review).
- The Act states that an accounting firm will not be able to provide audit services to an issuer if one of that issuer's top officials (for example, CEO, Controller, or CFO, Chief Accounting Officer) was employed by the firm and worked on the issuer's audit during the previous year.

Effective Date and Transition

For accounting and financial reporting provisions of this Guide that describe authoritative literature, effective dates should be applied as provided for in the related literature.

The following table shows how each chapter applies to entities covered by the Guide. These chapters or sections thereof, would apply to an entity only to the extent it engages in such activities.

Chapter	*Description*	*Banks and Savings Institutions*	*Credit Unions*	*Finance Companies*	*Mortgage Companies*
1	Industry Overview —Banks and Savings Institutions	X			
2	Industry Overview —Credit Unions		X		
3	Industry Overview —Finance Companies			X	
4	Industry Overview —Mortgage Banking				X
5	Audit Considerations and Certain Financial Reporting Matters	X	X	X	X
6	Cash and Cash Equivalents	X	X	X	X

(continued)

Chapter	Description	Banks and Savings Institutions	Credit Unions	Finance Companies	Mortgage Companies
7	Investments in Debt and Equity Securities	X	X	X	X
8	Loans	X	X	X	X
9	Credit Losses	X	X	X	X
10	Transfers of Loans and Mortgage Banking Activities	X	X	X	X
11	Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets	X	X	X	X
12	Other Assets, Other Liabilities, and Other Investments	X	X	X	X
13	Deposits	X	X		
14	Federal Funds and Repurchase Agreements	X	X	X	X
15	Debt	X	X	X	X
16	Income Taxes	X	(1)	X	X
17	Equity and Disclosures Regarding Capital Matters	X	X		X
18	Futures, Forwards, Options, Swaps, and Similar Financial Instruments	X	X	X	X
19	Business Combinations	X	X	X	X
20	Trust Services and Activities	X	(2)		
21	Insurance Activities	X	(2)	X	X
22	Reporting Considerations	X	X	X	X
App. A	FDI Act Reporting Requirements	X			
App. B	Regulatory Accounting Principles (RAP) and RAP/GAAP Differences	X	X		
App. C	Information Sources	X	X	X	X

(1) Federal credit unions are exempt from federal and state income tax. State chartered credit unions are also exempt from federal income tax, but may be subject to state income tax. The activities of a credit union service organization (CUSO) are typically subject to federal and state income taxes.

(2) Federal credit unions are not permitted to engage directly in trust service or insurance activities. However, these activities may be permissible for some state-chartered credit unions or CUSOs.

TABLE OF CONTENTS

Chapter 1

Industry Overview—Banks and Savings Institutions[*]

Description of Business

1.01 Banks and savings institutions provide a link between entities that have capital and entities that need capital. They accept deposits from entities with idle funds and lend to entities with investment or spending needs. This process of financial intermediation benefits the economy by increasing the supply of money available for investment and spending. It also provides an efficient means for the payment and transfer of funds between entities.

1.02 Government, at both the federal and state levels, has long recognized the importance of financial intermediation by offering banks and savings institutions special privileges and protections. These incentives—such as access to credit through the Federal Reserve System and federal insurance of deposits—have not been similarly extended to commercial enterprises. Accordingly, the benefits and responsibilities associated with their public role as financial intermediaries have brought banks and savings institutions under significant governmental oversight. Federal and state regulations affect every aspect of banks and savings institutions' operations. Similarly, legislative and regulatory developments in the last decade have radically changed the business environment for banks and savings institutions.

1.03 Although banks and savings institutions continue in their traditional role as financial intermediaries, the ways in which they carry out that role have become increasingly complex. Under continuing pressure to operate profitably, the industry has adopted innovative approaches to carrying out the basic process of gathering and lending funds. The management of complex assets and liabilities, searches for additional sources of income, reactions to technological advances, responses to changes in regulatory policy, and competition for deposits have all added to the risks and complexities of the business of banking. These include the following:

- Techniques for managing assets and liabilities that allow institutions to manage financial risks and maximize income have continued to evolve.
- Income, traditionally derived from the excess of interest collected over interest paid, has become increasingly dependent on fees and other income streams from specialized transactions and services.
- Technological advances have accommodated increasingly complex transactions, such as the sale of securities backed by cash flows from other financial assets.
- Regulatory policy has alternately fostered or restricted innovation, for example, as institutions look for new transactions to accommodate changes in the amount of funds, they must keep in

[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

reserve or to achieve the levels of capital that they must maintain in relation to their assets.

1.04 Increased competition has come from within the industry, and also from nontraditional competitors such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial enterprises. These entities now do business directly with potential depositors and borrowers in transactions traditionally executed through banks and savings institutions. This disintermediation has increased the need for innovative approaches to attracting depositors and borrowers.

1.05 Credit-card operations are an example of a banking activity that reflects the innovations and complexities of today's banks and savings institutions. Basically another means of lending, credit-card operations provide additional income through interest charges and related fees. Technological advances have made it possible to trade assets backed by cardholders' outstanding balances. The sale of such securities can help the institution manage its other assets and liabilities, as well as maintain regulatory capital levels. At the same time, competition from credit-card operations outside the banking and savings institutions industry creates pressure for further innovation.

1.06 Sources of income derived from nontraditional loan products have become common due to increased competition. The most common feature of nontraditional loans is a high loan-to-value ratio. Other features include, but are not limited to: Terms that permit principle payment deferrals, interest only loans, and option ARMS that may expose the borrower to higher interest rates at a later date.

1.07 The innovation and complexity that result from the industry's pursuit of profitable activities create a constantly changing body of business and economic risks. These risk factors, and related considerations for independent accountants, are identified and discussed throughout this Audit and Accounting Guide (the Guide).

Regulation and Oversight

1.08 As discussed above, the importance of financial intermediation has driven governments to play a role in the banking and savings institutions industry from its beginning. Banks and savings institutions have been given unique privileges and protections, including the insurance of their deposits by the federal government through the Federal Deposit Insurance Corporation (FDIC) and access to the Federal Reserve System's discount window and payments system. Currently, the federal oversight of institutions receiving these privileges falls to the following four agencies:

a. The Board of Governors of the Federal Reserve System (FRB), established in 1913 as the central bank of the United States with supervisory responsibilities for bank holding companies, state chartered banks that are members of the Federal Reserve System and foreign banking organizations operating in the United States

b. The FDIC, established in 1934 to restore confidence in the banking system through the federal insurance of deposits with supervisory responsibilities for state chartered banks that are not members of the Federal Reserve System *c.* The Office of the Comptroller of the Currency (OCC), created in 1863 to regulate and provide federal charters for national banks

d. The Office of Thrift Supervision (OTS), which replaced the Federal Home Loan Bank Board in 1989 as the primary regulator for savings institutions

1.09 The FRB and FDIC are independent agencies of the federal government. The OCC and OTS are separate bureaus of the U.S. Department of the Treasury. Each state has a banking department and are members of an organization called the Conference of State Supervisors.

1.10 Although each agency has its own jurisdiction and authority, the collective regulatory and supervisory responsibilities of federal and state banking agencies include—

- Establishing (either directly or as a result of legislative mandate) the rules and regulations that govern institutions' operations
- Supervising institutions' operations and activities
- Reviewing and approving organization, conversion, consolidation, merger, or other changes in control of the institutions and their branches
- Appraising (in part through on-site examinations) institutions' financial condition, the safety and soundness of operations, the quality of management, and compliance with laws and regulations

1.11 Given the nature of their duties, the banking agencies also have significant influence on the development of banks and savings institutions' accounting and reporting practices. For example, the agencies also have certain authority over the activities of independent accountants serving the industry. Further, the FRB, FDIC, OCC, OTS and the National Credit Union Administration (NCUA) constitute the Federal Financial Institutions Examination Council (FFIEC). The FFIEC sets forth uniform examination and supervisory guidelines in certain areas related to banks' and savings institutions' and credit unions' activities, including those involving regulatory accounting and financial reporting.

1.12 This chapter discusses the current regulatory approach to the supervision of banks and savings institutions and provides an overview of major areas of regulation and related regulatory reporting. Legislative efforts over time to regulate, deregulate, and reregulate banks and savings institutions are also addressed in this chapter. Other specific regulatory considerations are identified throughout this Guide in the relevant chapters.

1.13 In addition to supervision and regulation by the federal and state banking agencies, publicly held holding companies are generally subject to the requirements of federal securities laws, including the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the Exchange Act). Holding companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC). Publicly held institutions that are not part of a holding company are required under section 12(i) of the Exchange Act to make equivalent filings directly with their primary federal regulators. Each of the agencies has regulations that provide for the adoption of forms, disclosure rules, and other registration requirements equivalent to those of the SEC as mandated by the Exchange Act. (See footnote 1 in the Preface of this Guide.)

1.14 Both the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) were adopted to protect the federal deposit insurance funds through the early detection and intervention in problem institutions, with an emphasis on capital adequacy.

1.15 Declining real estate markets in the mid 1980s contributed heavily to widespread losses in the savings institutions industry, evidenced by the insolvency of the savings industry's federal deposit insurance fund. The FIRREA provided funds for the resolution of thrift institutions, replaced the existing regulatory structure, introduced increased regulatory capital requirements, established limitations on certain investments and activities, and enhanced regulators' enforcement authority. The FIRREA redefined responsibilities for federal deposit insurance by designating separate insurance funds, the Bank Insurance Fund (BIF), and the Savings Associations Insurance Fund (SAIF). The FIRREA also established the Resolution Trust Corporation (RTC) to dispose of the assets of failed thrifts. The RTC is no longer in existence and its work is now being done by the FDIC.

1.16 As the 1980s came to a close, record numbers of bank failures began to drain the BIF. The FDICIA provided additional funding for the BIF but also focused the least-cost resolution of and prompt corrective action for troubled institutions and improved supervision and examinations. The FDICIA also focused the regulatory enforcement mechanism on capital adequacy. Many of the FDICIA's provisions were amendments or additions to the existing Federal Deposit Insurance (FDI) Act.

1.17 In 1995, BIF reached its statutorily mandated ratio of insurance funds to insured deposits of 1.25 percent. The SAIF was capitalized at a 1.25 percent ratio of insurance funds to insured deposits after passage of the Deposit Insurance Funds Act of 1996. In April 2006 the FDIC merged the BIF and the SAIF to form the Deposit Insurance Fund (DIF), effective March 31, 2006. This action was pursuant to the provisions in the Federal Deposit Insurance Reform Act of 2005 and the FDIC has amended its regulations to reflect the merger of these funds.

1.18 A desire to allow banks to serve a broad spectrum of customer financial needs caused Congress to pass new legislation in 1999. The Gramm-Leach-Bliley Act (or also known as the Financial Services Modernization Act) has changed the types of activities that are permissible for bank holding company affiliates and for subsidiaries of banks. The bill created so-called *financial holding companies* that may engage in a broad array of activities. Financial holding company affiliates may now provide insurance as principal, agent, or broker, and may issue annuities. These affiliates, as well as the direct subsidiaries of banks, may now engage in underwriting, dealing in, or making a market in securities. The legislation affirmed the concept of functional regulation. Federal banking regulators will continue to be the primary supervisors of the banking affiliates of financial holding companies, but state insurance authorities will supervise the insurance companies, and the SEC and securities self-regulatory organizations will supervise the securities business. Each functional regulator will determine appropriate capital standards for the companies it supervises. The U.S. Treasury and the Federal Reserve Board have the authority to approve additional activities to be permissible for financial holding companies. This authority includes consideration of merchant banking, but financial holding companies are subject to a five-year moratorium on this activity.

1.19 In 1970, the Bank Secrecy Act (BSA) was enacted to address the problem of money laundering. The BSA authorized the Treasury Department to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money-laundering programs and compliance procedures, and report suspicious transactions to the government. (See 31 CFR Part 103). These regulations, promulgated under the authority of the BSA, and subsequently the USA-Patriot Act of 2001, are intended to help federal authorities detect, deter and prevent criminal activity. The Financial Crimes Enforcement Network (FinCEN), an arm of the U.S. Department of the Treasury, administers these regulations.

1.20 On July 28, 2006, the FFIEC and related agencies released the revised Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual (Manual). The Manual emphasizes a banking organization's responsibility to establish and implement risk-based policies, procedures, and processes to comply with the BSA and safeguard its operations from money laundering and terrorist financing. The revised Manual reflects the ongoing commitment to provide current and consistent guidance on risk-based policies, procedures, and processes for banking organizations to comply with the BSA and safeguard operations from money laundering and terrorist financing. The Manual has been updated to further clarify supervisory expectations and incorporate regulatory changes since the Manual's 2005 release.

1.21 In 2002, the Sarbanes-Oxley Act, which applies in general to issuers and their audit firms, was passed. This legislation was enacted in response to high-profile business failures which called into question the effectiveness of the CPA profession's self-regulatory process as well as the effectiveness of the audit to uphold the public trust in the capital markets. The requirements of the Sarbanes-Oxley Act and the SEC regulations implementing the Act are wide-ranging. The banking regulatory agencies have also passed regulations implementing certain provisions of the Sarbanes-Oxley Act. See paragraphs 1.59–1.67 for more information about regulatory issuances related to the Sarbanes-Oxley Act. In addition, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), which has the authority to set and enforce auditing, attestation, quality control and ethics (including independence) standards for auditors of issuers. It also is empowered to inspect the auditing operations of public accounting firms that audit issuers as well as impose disciplinary and remedial sanctions for violations of the board's rules, securities laws and professional auditing and accounting standards.

1.22 Key economic issues affecting the regulations are centered on the ability of financial institutions to operate profitably—for example, the costs and benefits of regulations, the effects of unemployment and future corporate layoff plans, levels of interest rates, and the availability of credit.

1.23 Racial and ethnic disparities in residential lending and the extent of institutions' environmental liability are two of many social issues receiving continuing focus in federal regulation.

Regulatory Capital Matters[1]

1.24 Capital is the primary tool used by regulators to monitor the financial health of insured financial institutions. Regulatory intervention is focused primarily on an institution's capital levels relative to regulatory standards. The agencies have a uniform framework for prompt corrective action, as well as specific capital adequacy guidelines set forth by each agency.[2]

1.25 In addition to assessing financial statement disclosures which are discussed in Chapter 17, "Equity and Disclosures Regarding Capital Matters," the independent accountant considers regulatory capital from the perspective that noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. This discussion provides an overview to help independent accountants understand regulatory capital requirements. Capital regulations are complex and their application by management requires a thorough understanding of specific requirements and the potential impact of noncompliance. Accordingly, the independent accountant should consult the relevant regulations and regulatory guidance, as necessary, when considering regulatory capital matters.

Capital Adequacy

1.26 The FDIC, OCC, and the FRB historically had common capital adequacy guidelines which differed in some respects from those of the OTS involving minimum (*a*) leverage capital and (*b*) risk-based capital requirements.[3,4] Capital adequacy guidelines are now substantially the same for banks and savings associations. A summary of the general requirements follows. Specific requirements are set forth in Title 12 of the Code of Federal Regulations (12 CFR) and in the instructions for FFIEC Consolidated Reports of Condition and Income and OTS Thrift Financial Reports (collectively, *call reports*). Call reports, which are required to be filed quarterly, contain certain financial information, including that used in calculating regulatory capital amounts.[5]

1.27 The first requirement establishes a minimum ratio of capital as a percentage of total assets. The FDIC, OCC, FRB, and OTS require institutions to maintain a minimum leverage ratio of Tier 1 capital (as defined) to total average assets based on the institution's rating under the regulatory composite CAMELS rating system. (The CAMELS rating derives its name from the

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[1] On March 1, 2005 the Federal Reserve Board amended the Tier Capital Requirements for Trust Preferred Securities. For additional information concerning this amendment, readers may refer to www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/default.htm

[2] This chapter discusses federal capital requirements. Separate state requirements may exist that also should be considered for purposes of assessing the entity's ability to continue as a going concern.

[3] Savings institution holding companies are not subject to regulatory capital requirements separate from those of their subsidiaries. Bank holding companies do have capital requirements separate from those of their subsidiaries.

[4] Effective December 26, 2006 the federal bank and thrift regulatory agencies have jointly issued Notice of Proposed Rulemaking (NPR) and are seeking comment on possible modifications to the risk-based capital standards for banks, holding companies, and savings associations that are not affected by the guildelines proposed in NPR on Basel II (www.fdic.gov/news/news/financial/2006/fil06111.html). Please see FIL 111-2006 for additional supervisory guidance on this issue.

[5] The Federal Financial Institutions Examination Council (FFIEC) has approved revisions to the reporting requirements for the Reports of Condition and Income (Call Report) that will be phased in over the next two years. The revision of existing items and the addition of new items will be spread over the period from March 31, 2006 through March 31, 2008. See FIL-7-2006 dated January 27, 2006.

various components of a depository institution that are rated, namely, capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to interest rates. Actually, the "S" is sensitivity to market risk and a component of market risk is sensitivity to interest rate changes or more commonly expressed as sensitivity to interest rate risk.) The minimum Tier 1 leverage ratio for institutions with CAMELS ratings of 1 is 3.0 percent. For all others the minimum ratio is 4.0 percent. As a practical matter, a Tier 1 leverage ratio of less than 6 percent will generally result in concern by the regulators. By statute, OTS also requires all savings institutions to maintain a tangible capital requirement of 1.5 percent of assets.

1.28 The second requirement also establishes a minimum ratio of capital as a percentage of total assets but gives weight to the relative risk of each asset, including off-balance-sheet positions. The FDIC, OCC, and FRB require institutions to maintain a minimum ratio of Tier 1 capital to risk-weighted assets of 4.0 percent. Banks must also maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent. Banks are expected to maintain capital above these minimum levels.

1.29 For savings associations, the OTS-required minimum total risk-based capital ratio (that is, the total of core and supplemental capital) is also 8.0 percent. Tier 2 capital may not exceed 100 percent of Tier 1 (leverage) capital.

1.30 On July 3, 2006, the OTS proposed to update section 12 of the Code of Federal Regulations (CFR) 563.81. The proposal serves as a final review of 12 CFR 563. The final rule updates regulations that require savings associations to obtain approval before it may include subordinated debt securities or mandatorily redeemable preferred stock in supplementary (tier 2) capital. The final rule removes several unnecessary or outdated requirements, as well as conforming other provisions, such as maturity period requirements and purchaser restrictions. The final rule also reconciles conflicting rules, adds appropriate statutory references and rewrites the rule in plain language. The effective date for the final rule is April 1, 2007.

1.31 Risk-based capital standards of the FDIC, OCC, and FRB explicitly identify concentrations of credit risk, risks of nontraditional activities, and interest-rate risk as qualitative factors to be considered in examiner assessments of an institution's overall capital adequacy; however, the standards require no specific quantitative measure of such risks. OTS does not have explicit standards in its capital rule but does have similar written guidelines, standards, and criteria that are virtually the same as the banking agencies.

1.32 The FDIC, OCC, and FRB have augmented their interest-rate risk requirements through a joint policy statement that explains how examiners will assess institutions' interest-rate risk exposure.[6] The policy statement also suggests that institutions with complex systems for measuring interest-rate risk may seek assurance about the institution's risk management process from external auditors. OTS is not a part of the joint policy statement. OTS, like the other banking agencies, has provided written guidance on sound practices for managing interest-rate risk, and directs examiners to take into account interest-rate risk when assessing capital adequacy during each safety and soundness examination.

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[6] *Federal Register* 61, no. 124 [26 June 1996]: 33166. The joint policy statement was transmitted by OCC Bulletin 96-36, FDIC Financial Institutions Letters [FILs] 52-96 and 54-96, and FRB Supervisory Letter (SR) 96-13.

1.33 The federal bank and thrift regulatory agencies issued a joint notice of proposed rulemaking (NPR) on possible modifications to the risk-based capital standards for market risk. The proposal would incorporate improvements to the trading book regime based on the joint document *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, published by the Basel Committee on Bank Supervision in July 2005.[7]

1.34 The concept of Tier 3 capital was established when the FDIC, OCC, and FRB amended their respective risk-based capital standards to incorporate a measure for market risk. The effect of this rule is that any bank or bank holding company regulated by the federal banking agencies, with significant exposure to market risk, must measure that risk using its own internal value at risk model, and must hold a commensurate amount of capital. This requirement only applies to banks and bank holding companies whose trading activity on a worldwide consolidated basis equals 10 percent or more of the total assets or $1 billion or more. Market risk rules may be applied to any insured state nonmember bank if the FDIC deems it necessary for safety and soundness practices.

1.35 Institutions are required to report certain financial information to regulators in quarterly call reports, which include amounts used in calculations of the institution's various regulatory capital amounts.

Prompt Corrective Action

1.36 FDICIA made capital an essential tool of regulators to monitor the financial health of insured banks and savings institutions. Regulatory intervention is now focused primarily on an institution's capital levels relative to regulatory standards. Through Section 38 of the FDI Act, FDICIA added (to the existing capital adequacy guidelines set forth by each agency) a uniform framework for prompt corrective regulatory action. Holding companies are not subject to the prompt corrective action provisions.

1.37 Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories (see paragraph 1.35 below) based primarily on three capital measures, namely, Tier 1 leverage; total risk-based; and Tier 1 risk-based capital. These capital ratios are defined in the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, Tier 1 leverage capital is comparable to core capital (as defined).

1.38 Regulations also specify a minimum requirement for tangible equity, which is defined as Tier 1 capital plus cumulative perpetual preferred stock, net of all intangibles except mortgage servicing assets (MSAs) to the extent that they can be included in Tier 1 capital. In calculating the tangible capital ratio, intangibles (except for qualifying MSAs) should also be deducted from total assets included in the ratio denominator.

1.39 An institution may be reclassified between certain capital categories if its condition or an activity is deemed by regulators to be *unsafe or unsound*. A change in an institution's capital category initiates certain mandatory—and possibly additional discretionary—action by regulators.

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[7] FDIC Financial Institution Letter, FIL-87-2006, issued September 25, 2006.

1.40 Under Section 38 of the Act, an institution is considered:

a. *Well capitalized* if its capital level *significantly exceeds* the required minimum level for each relevant capital category.

b. *Adequately capitalized* if its capital level *meets* the minimum levels.

c. *Undercapitalized* if its capital level *fails to meet* the minimum levels.

d. *Significantly undercapitalized* if its capital level *is significantly below* the minimum levels.

e. *Critically undercapitalized* if it has a ratio of tangible equity to total assets (as defined) of 2 percent or less, or otherwise fails to meet the critical capital level (as defined).

1.41 The minimum levels are defined as follows:

Category	*Total Risk-based Ratio (Percent)*		*Tier 1 Risk-based Ratio (Percent)*		*Tier 1 Leverage Capital Ratio (Percent)*
Well capitalized	≥ 10	and	≥ 6	and	≥ 5
Adequately capitalized	≥ 8	and	≥ 4	and	≥ 4*
Undercapitalized	< 8	or	< 4	or	< 4*
Significantly undercapitalized	< 6	or	< 3	or	< 3

* 3.0 percent for institutions with a rating of one under the regulatory CAMELS or related rating system that are not anticipating or experiencing significant growth and have well-diversified risk (as defined).

1.42 As noted above, critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

1.43 An institution will not be considered well capitalized if it is under a capital-related cease-and-desist order, formal agreement, capital directive, or prompt corrective action capital directive.

1.44 Actions that may be taken under the prompt corrective action provisions range from the restriction or prohibition of certain activities to the appointment of a receiver or conservator of the institution's net assets.

1.45 Regulators will also require undercapitalized institutions to submit a plan for restoring the institution to an acceptable capital category. For example, each undercapitalized institution is required to submit a plan that specifies:

- Steps the institution will take to become adequately capitalized
- Targeted capital levels for each year of the plan
- How the institution will comply with other restrictions or requirements put into effect
- Types and levels of activities in which the institution will engage

1.46 Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the prompt corrective action provisions warrants similar attention by independent accountants when considering an institution's ability to remain a going concern.

Regulatory Requirements for Independent Reporting Under FDI Act

1.47 The primary source of independent reporting requirements is Section 36 of the FDI Act, as added to the FDICIA. Section 36 establishes reporting requirements for reports by management and independent accountants. It also establishes minimum qualifications for independent accountants serving the affected institutions. The underlying provisions, as summarized below, apply to each FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[8] For additional regulatory requirements refer to paragraph 1.61.

1.48 Notwithstanding the FDI Act requirements, the FRB requires certain bank holding companies to submit audited financial statements (under authority of 12 CFR Subpart 225.5 [Regulation Y]).

1.49 Also, the OTS Audit Rule at 12 CFR 562.4 requires the following entities to be audited: All audited financial statements submitted to the OTS are subject to the SEC independence requirements. Other entities subject to audit:

- Thrifts, regardless of size, with a composite safety and soundness CAMELS rating of 3, 4, or 5
- Holding companies which control insured financial institution subsidiary(ies) with aggregate consolidated assets of $500 million or more
- Any other entity for which the OTS determines an audit is required for safety and soundness reasons

1.50 To implement the FDICIA requirements, the FDIC issued both a final regulation and accompanying guidelines and interpretations (*guidelines*). The general requirements are summarized below.

1.51 ***Annual Report.*** Management is required to prepare, annually, a report that includes the following:[9]

a. Financial statements prepared in conformity with generally accepted accounting principles (GAAP)

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[8] The banking agencies have adopted the FFIEC Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations. For the FDIC, it replaces the FDIC's "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks." The other banking agencies have also adopted the interagency policy statement. The interagency policy statement encourages institutions to adopt an annual external auditing program and, where practicable, to establish an audit committee composed entirely of outside directors. The interagency policy statement states that the banking agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The statement also describes two alternatives to a financial statement audit that an institution may elect to have performed annually in order to have an acceptable external auditing program.

[9] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in 12 CFR Subpart 363.1 of the rule and in guidelines 2 through 4 therein.

b. A written assertion about the effectiveness of the institution's internal controls over financial reporting at year-end

c. A written assertion about the institution's compliance during the year with (1) federal laws and regulations relative to insider loans and (2) federal and state laws and regulations relative to dividend restrictions

1.52 Management also must include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations. Management must engage an independent accountant to provide the following reports annually:

a. An audit report on financial statements prepared in conformity with GAAP

b. An examination-level attestation report on management's assertion about financial reporting controls

1.53 The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls is to be performed in accordance with Statements on Standards for Attestation Engagements (SSAEs).

1.54 The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the 90 days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

1.55 All of management's reports will be made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls will also be made publicly available. Any management letter, while filed with the FDIC and other agencies, will not be publicly available.

1.56 ***Qualifications of Independent Accountants.*** Acceptance of an engagement to report under Section 36 for banks and savings institutions is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Center for Public Company Audit Firms or Private Companies Practice Section, or enrollment in the AICPA's Peer Review Program, will satisfy this requirement. For auditors required to conduct their audits in accordance with PCAOB Standards, registration with the PCAOB is mandatory.

1.57 Another condition of the engagement is that the independent accountant agrees to provide regulators with access to audit documentation related to the two engagement reports. The implementing guidelines also call for providing copies of audit documentation to regulators, although this requirement is not explicit in the law or regulation. Independent accountants should be familiar with Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," in AU section 9339.01–.15, *Audit Documentation: Auditing Interpretations of Section 339* (AICPA, *Professional Standards*, vol. 1). In December of 2005, the Auditing Standards Board issued Statement of Auditing Standards (SAS) No. 103, *Audit Documentation*. SAS No. 103 supersedes AU section 339, *Audit Documentation* (AICPA *Professional Standards*, vol. 1), and amends AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). The Statement is effective for audits of financial statements for periods ending on or after December 15, 2006 with earlier application permitted.

1.58 The accountant must meet the independence requirements and interpretations of the SEC and its staff, whether or not the reporting bank or savings institution has securities outstanding that are registered under the 1933 Act or the Exchange Act.

1.59 The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. Independent accountants must also file peer review reports within fifteen days of acceptance of the report.

1.60 ***Enforcement Actions Against Accountants.*** Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. On August 13, 2003, the FRB, FDIC, OCC, and OTS issued a final rule on "Removal, Suspension, and Debarment of Accountants from Performing Audit Services."

1.61 ***Communication With Independent Accountants.*** Each institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

Other Reporting Considerations

1.62 Banks and savings institutions often engage independent accountants to perform assurance services other than those required by Section 36 of the FDI Act. Such engagements may relate to the following:

a. *Student Loans.* Lenders participating in the Federal Family Education Loan Program may be required to engage an independent accountant to examine and report on management's assertions regarding compliance with certain U.S. Department of Education requirements. This examination is performed in accordance with (1) *Government Auditing Standards* (GAS, also known as the Yellow Book) issued by the Comptroller General of the United States, (2) Chapter 6, "Compliance Attestation," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT section 601), and (3) the Audit Guide *Compliance Audits (Attestation Engagements) for Lenders and Lender Servicers Participating in the Federal Family Education Loan Program*, issued by the U.S. Department of Education. This examination requirement applies to lenders with origination levels exceeding a specified dollar amount.

b. *Federal Home Loan Mortgage Corporation Borrowings*. Banks or savings institutions that are members of the FHLMC system may borrow from their respective district Federal Home Loan Bank. Borrowings are generally secured by the pledging of assets, often in the form in a blanket lien. The district banks maintain separate and distinct credit policies that have varying requirements as to a member bank's engagement of independent accountants to render assurance services relating to the adequacy of collateral maintenance levels. It is incumbent on the independent accountant to ascertain the professional standards that may be applicable to the requested services. The engagement generally takes the form of (1) an agreed-upon procedures engagement performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1), or (2) an audit engagement performed in accordance with AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1).

c. *Loan Servicing*. Lenders who service mortgage loans for others may be required to engage an independent accountant to examine management's assertions about compliance with minimum servicing standards set forth in the Uniform Single Attestation Program for Mortgage Bankers. This examination is performed in accordance with Chapter 6, "Compliance Attestation," of SSAE No. 10, as further described herein in paragraphs 4.28 and 4.29.

d. *Department of Housing and Urban Development Programs*. To the extent that a bank or savings institution originates or services Department of Housing and Urban Development (HUD) loans through a subsidiary that is designated a *nonsupervised mortgagee*, compliance with the Consolidated Audit Guide for Audits of HUD Programs is required, as further described herein in paragraph 4.26.

Additional Regulatory Requirements Concerning the Sarbanes-Oxley Act, Corporate Governance, and Services Outsourced to External Auditors

1.63 In connection with the Sarbanes-Oxley Act of 2002, the SEC has issued regulations implementing sections of the Act, addressing various areas such as certification of financial statements, auditor independence, non-GAAP financial measures, accounting firms' record retention, audit committees, influencing auditors, and other matters. These regulations are not unique to financial institutions. Management, the board of directors, the audit committee, and auditors should be aware of the requirements of the Sarbanes-Oxley Act and the implementing SEC regulations.

1.64 In addition to the above, in May 2003, the SEC adopted rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to assess the effectiveness of their internal control and include in their annual reports a report of management on the company's internal control over financial reporting. The rule also mandates quarterly reports on changes in internal control. See paragraphs 1.62–1.66 for additional discussions and guidance about these rules.

1.65 The banking regulatory agencies have also implemented regulations in connection with the Sarbanes-Oxley Act. These regulations can affect nonpublic as well as public entities. These regulations include:

- On March 17, 2003, the FDIC, OTS, OCC, and FRB issued *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*. This policy statement reflects the passage of the Sarbanes-Oxley Act and prohibits an external auditor from providing internal audit services during the same period for which the external auditor expresses an opinion on the financial statements.

This prohibition applies to banks, savings associations, and their holding companies that:

(1) Have a class of securities registered with either the SEC or the OTS under Section 12 of the Securities Exchange Act of 1934 or are required to file reports with the SEC under Section 15 (d) of that Act (commonly referred to as public companies) and therefore required to have an external audit.

(2) Savings associations and banks with assets of $500 million or more that are subject to the FDIC's external audit and reporting requirements under 12 CFR Part 363.

(3) Savings associations and savings association holding companies that are required to have an external audit by the OTS pursuant to 12 CFR Part 562.

For all other banks, savings associations and their holding companies that have external audits of their financial statements but are not required to do so, the policy encourages such organizations to follow the internal audit outsourcing prohibition in Section 201 of the Sarbanes-Oxley Act when the SEC's regulations implementing this prohibition take effect.

- On March 5, 2003, the FDIC issued *Financial Institutions Letter 17-2003 (FIL-17), Corporate Governance, Audits, and Reporting Requirements* and the FRB, OCC and OTS, in May 2003, issued *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations*. This Letter and Statement require or recommend that certain non-public financial institutions comply with certain sections of the Sarbanes-Oxley Act. External auditors should be familiar with the guidance. The Letter notes that "the FDIC is considering possible amendments to Part 363 of its regulations that would extend certain provisions of the Sarbanes-Oxley Act that were described in Attachment I to all insured institutions with $500 million or more in total assets (covered institutions), whether or not they are public companies or subsidiaries of public companies. Any amendments to Part 363 would be developed in consultation with the other banking agencies and would be published in proposed form for public comment in the *Federal Register*." Readers should be alert to such issuances.
- On August 12, 2003, the FDIC, the OCC, the FRB, and the OTS jointly issued final rules that establish procedures, under which the agencies could remove, suspend or bar an accountant or firm from performing audit and attestation services for insured depository institutions subject to the annual audit and reporting requirements of Section 36 of the Federal Deposit Insurance Act. Section 36 applies to institutions with $500 million or more in total assets.
- Effective April 1, 2003, the FRB adopted a final rule to reflect the amendments made to section 12(i) of the Securities Exchange Act of 1934. These amendments vest the FRB with the authority to administer and enforce several of the enhanced reporting, disclosure and corporate governance obligations imposed by the Sarbanes-Oxley Act in respect to state member banks that have

a class of securities registered under the Securities Exchange Act of 1934.

On April 8, 2003, the OTS issued CEO letter number 173, "Filing of Section 906 Sarbanes-Oxley Act Certifications with OTS." Certain thrifts that are issuers of public securities file their public reports with the OTS instead of the SEC under section 12(i) of the Securities Exchange Act of 1934. Pending any different guidance from the Department of Justice, the section 906 certificates should accompany the periodic reports that are filed with the OTS. The certificates should be worded in the same manner as the statutory requirement and each certifying officer should sign a separate certificate.

- On June 30, 2005, the Federal Financial Institutions Examination Council (FFIEC) issued the Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual. The manual was the result of a collaborative effort of the federal banking agencies and the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN).The manual does not set new standards; instead, it is a compilation of existing regulatory requirements, supervisory expectations, and sound practices in the BSA/AML area.
- On November 28, 2005, the FDIC amended Part 363 of its regulations by raising the asset-size threshold from $500 million to $1 billion for internal control assessments by management and external auditors. For institutions between $500 million and $1 billion in assets, only a majority, rather than all, of the members of the audit committee, who must be outside directors, must be independent of management. The amendments take effect December 28, 2005, and apply to institutions whose fiscal years end on or after September 30, 2005.

1.66 ***Sarbanes-Oxley Act Section 404 and the FDIC Improvement Act of 1991.*** Public companies that are subject to FDICIA (more than $500 million in assets) must prepare reports for the SEC, FDIC, and their regulator that are similar in nature. As stated in paragraph 1.59, the SEC issued a final rule, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* effective August 12, 2003. Section 404(a) of the Sarbanes-Oxley Act mandates that registrants (1) take responsibility for establishing and maintaining adequate internal control structure and procedures and (2) assess their effectiveness at the end of each fiscal year. Management must create a Management's Annual Internal Control Report as part of the Annual Report. (Quarterly updating is necessary only if the internal control environment has changed or is likely to change materially.) The report needs to contain the following:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control
- Management's assessment of the effectiveness of internal control as of the end of the company's most recent fiscal year
- Disclosure of any material weaknesses

- A statement that its auditor has issued an attestation report on management's assessment. (The company must include this report in the company's annual report.)

1.67 The SEC coordinated with the FDIC to eliminate any unnecessary duplication between the aforementioned requirements and section 36 of FDICIA. Many internal control requirements of the Sarbanes-Oxley Act were structured after the FDICIA. A comparison of Sarbanes-Oxley and the FDICIA Management Requirements are indicated below for clarity.

Sarbanes-Oxley	*FDICIA*
A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company	A statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting (Financial reporting must encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory purposes.)
Not required by Sarbanes-Oxley	A statement of management's responsibility for preparing the institution's financial statements
Not required by Sarbanes-Oxley	A statement of management's responsibility for complying with designated laws and regulations relating to safety and soundness
A statement identifying the framework used by management to evaluate the effectiveness of this internal control	Not required by FDICIA. (The FDIC's regulations do not specifically require that management identify the control framework used to evaluate the effectiveness of the institution's internal control over financial reporting. However, given certain attest requirements, the FDIC believes that the framework used must be disclosed or otherwise be publicly available to all users of reports that institutions file with the FDIC pursuant to part 363 of the FDIC's regulations.)
Management's assessment of the effectiveness of internal control as of the end of the company's most recent fiscal year	Management's assessment of the effectiveness of the institution's internal control structure and procedures for financial reporting as of the end of the fiscal year
Disclosure of any material weakness (and the related stipulation that management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses)	Not required by FDICIA
A statement that a registered public accounting firm has issued an attestation report on management's assessment	Not required by FDICIA

Sarbanes-Oxley	*FDICIA*
Inclusion of the registered public accounting firm's attestation report on management's assessment in the Annual Report	The regulations do not require the accountant to be a registered public accounting firm. However, the FDIC's regulations do require inclusion of the independent public accountant's attestation report on management's assertions concerning the effectiveness of the institution's internal control structure and procedures for financial reporting in the FDICIA report

1.68 Insured depository institutions that are subject to part 363 of the FDIC's regulations (as well as holding companies permitted to file an internal control report on behalf of their insured depository institution subsidiaries in satisfaction of the FDIC and SEC regulations) can choose to either prepare two separate management reports to satisfy the FDIC's and Sarbanes-Oxley Act Section 404 requirements or prepare a single management report that satisfies both the FDIC and Sarbanes-Oxley Act Section 404 requirements.

1.69 If a single report is prepared it must contain the following combined requirements of the above chart:

- A statement of management's responsibility for preparing the registrant's annual financial statements, for establishing and maintaining adequate internal control over financial reporting for the registrant, and for the institution's compliance with laws and regulations relating to safety and soundness designated by the FDIC and the appropriate federal banking agencies.
- A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by the Exchange Act rule 13a-15 or 15d-15.
- Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not management has concluded that the registrant's internal control over financial reporting is effective, and of the institution's compliance with the designated safety and soundness laws and regulations during the fiscal year. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management.
- A statement that the registered public accounting firm that audited the financial statements included in the registrant's annual report, has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

Finally, it is important to note that the institution or holding company will have to provide the registered public accounting firm's attestation report on management's assessment in its annual report filed under the Exchange Act. For purposes of the report of management and the attestation report, financial reporting must encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes.

1.70 Section 404(b) of the Act requires the external auditor to attest to, and publicly report on management's assessments of the effectiveness of the company's internal controls and procedures for financial reporting. Auditors are expected to expand their scope in relation to internal control. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the PCAOB. Section 404(b) states, that any such attestation shall not be the subject of a separate engagement. In the past, auditors did not usually identify internal control weaknesses in their audit reports unless the weakness was material. Instead they would be in the form of "management letters" which were not required to be disclosed to the public. Section 404 of the Sarbanes-Oxley Act does not specify where the management report should appear. However, there is a preference that companies should place the report on internal controls close to the corresponding attestation report issued by the auditors. Positioning the report near the company's Management's Discussion and Analysis disclosure or immediately preceding the company's financial statements would be two appropriate locations.

1.71 In connection with the requirements of Section 404,[10] Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), established requirements when performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB Standards.

Regulatory Requirements For Internationally Active Banks

1.72 On September 25, 2006, the FDIC, OCC, OTS, and FRB requested comments on a NPR that would implement new risk based Capital requirements for the large, internationally active banks in the United States. The NPR outline highlights the agencies plans for implementing BASEL II.

1.73 Banks that do not implement Basel II would apply Basel 1A, which is in substance, alterations to the current risk-based capital standards.

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[10] See the PCAOB Web site at www.pcaobus.org for information about the effective dates for issuers.

Chapter 2

Industry Overview—Credit Unions

Description of Business

2.01 The first credit union in the United States was organized in 1909. Although credit unions originally arose within communities, greater success was achieved by organizing credit unions to serve employee groups—particularly government employees, teachers, railway workers, and telephone company employees.

2.02 In 1934, Congress passed the Federal Credit Union Act (FCUA), establishing a federal regulatory system. In 1970 the National Credit Union Administration (NCUA), an independent governmental agency, was created by Congress to charter, supervise, and regulate federal credit unions. Other legislative initiatives that have affected credit unions include the following:

- The creation of the National Credit Union Share Insurance Fund (NCUSIF) within the NCUA to insure share (deposit) accounts up to applicable limits in all federal credit unions and many state-chartered credit unions
- The Depository Institution Deregulation and Monetary Control Act of 1980
- The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)
- The Credit Union Membership Access Act of 1998 (CUMAA)
- The Gramm-Leach-Bliley Act of 1999 (also known as the Financial Services Modernization Act)

2.03 Each credit union is organized around a defined *field of membership*, and each member shares a *common bond* of affiliation with other members. The field of membership is a key characteristic of a credit union, and is defined in its charter or bylaws as those who may belong to it and use its services. All credit unions, except corporate credit unions are referred to as "natural person credit union". The common bond is a characteristic of the members themselves. Congress, in the Federal Credit Union Act (FCUA), has recognized three federal credit union common bonds, namely, occupational, associational, and community. A federal credit union may also consist of a combination of occupational, associational, and, in certain limited circumstances, community groups. For example, the NCUA may charter a federal credit union consisting of the employees of a local school district and members of a church group.

2.04 In early 1998, the United States Supreme Court ruled that NCUA had strayed from the original intent of Congress as reflected in the FCUA passed in 1934 relating to common bond affiliation for credit union membership. This ruling had the effect of restricting future membership in federal credit unions. On August 7, 1998, legislation was signed into law that eased membership restrictions on credit unions and allowed them to expand. The legislation, known as the CUMAA, permits occupation-based credit unions to take in groups of members from unrelated companies under certain circumstances.

2.05 CUMAA also establishes three important new requirements with respect to financial statements and audits. First, all federally insured credit unions with assets of $500 million or more must obtain an annual independent audit of their financial statements by a certified public accountant or licensed public accountant. Second, all federally insured credit unions with assets of $10 million or more must follow generally accepted accounting principles (GAAP) for all reports or statements required to be filed with the NCUA Board. Third, for any federal credit union with assets of more than $10 million that uses an independent auditor who is compensated for his or her services, the audit is subject to state accounting laws, including licensing requirements.

2.06 CUMAA addressed minimum capital requirements and Prompt Corrective Action (PCA) to restore capital. New net worth standards based on a percentage of assets was established for insured credit unions, as well as risk-based capital standards for complex credit unions as defined by the NCUA. NCUA also developed PCA regulations, as well as regulations concerning other areas such as new field of membership rules, and supervisory committee audit rules as required by this legislation. In addition, CUMAA placed restrictions on member business lending and restricted conversions to mutual savings banks.

The Board of Directors

2.07 The board of directors establishes the general operation of a credit union and ensures that it follows applicable laws and regulations and adheres to its bylaws. In addition, the board is responsible for ensuring that a credit union maintains its financial stability, follows good business practices, and is properly insured and bonded. As membership organizations, credit unions are democratically controlled. Federal and state laws require that a board of directors be elected by the membership on the basis of one member, one vote. The board of directors in turn appoints the supervisory committee. The supervisory committee, which is similar to an audit committee, plays a major role in monitoring a credit union's financial affairs. A credit committee may be appointed or elected to oversee the lending transactions. Other committees may include a budget or finance committee, a marketing or member-relations committee, an educational committee, and various *ad hoc* committees. Credit unions depend heavily on member volunteers to set policy, make decisions, and sometimes even to operate them. Some officials (board members and board appointed persons) of state chartered credit unions may receive compensation for services, as allowed by law. However, federally chartered credit unions, except as expressly stated in Section 701.33(b) of the NCUA Rules and Regulations, are generally prohibited from compensating officials.

The Supervisory Committee

2.08 The supervisory or audit committee is responsible for ensuring that member funds are protected, financial records and operations are in order, and elected officials carry out their duties properly. Supervisory committee responsibilities are prescribed in part 715 of the NCUA Rules and Regulations. In addition, the supervisory committee is generally responsible for overseeing the financial reporting process and ensuring that management has established effective internal control. Section 115 of the FCUA (12 U.S.C. §1761d) states:

> The supervisory committee shall make or cause to be made an annual audit and shall submit a report of that audit to the Board of

> Directors and a summary of the report to the members at the next annual meeting of the credit union; shall make or cause to be made such supplemental audits as it deems necessary or as may be ordered by the Board, and submit reports of the supplementary audits to the Board of Directors.

Similar requirements exist for most state-chartered credit unions. The supervisory committee may engage an independent auditor to audit and report on the credit union's financial statements.

2.09 Supervisory committees play an important role in developing and maintaining strong operational and financial management at credit unions. As credit unions continue to broaden the nature and scope of the activities in which they are involved, it is important that supervisory committees meet regularly and carefully review operational and financial goals, internal control, financial statements, and examiners' and auditors' reports. Lack of supervisory committee involvement in credit union operations may be an early indicator of potential problems for credit unions.

The Credit Committee

2.10 The credit committee (composed of volunteers elected by the membership) establishes and monitors a credit union's lending policies, approves loan applications, and provides credit-counseling services to members. This committee may delegate some of its loan-granting authority to one or more loan officers employed by the credit union in accordance with the bylaws. Many credit unions have amended their bylaws to eliminate the elected credit committee. In these instances, the board of directors assumes credit committee responsibilities and generally delegates its responsibility to loan officers employed by the credit union.

Chapter, Bylaws, and Minutes

2.11 The NCUA issues charters for federally chartered credit unions and prescribes the form of bylaws of such credit unions. State regulatory authorities establish the form of the charter and bylaws for state-chartered credit unions. The regulatory authorities generally require monthly meetings of the board of directors and other volunteer committees.

Financial Structure

2.12 Because they are nonstock cooperatives, credit unions' primary source of funds is members' share and savings account deposits. To be entitled to membership, each member must generally own at least one share in the credit union. Members' shares or share accounts are savings accounts that represent the members' ownership in the credit union. Credit unions pay interest (commonly referred to as *dividends*) on shares. This interest cannot be guaranteed (as interest on deposits can), but must be declared by the board and may be paid from current earnings or undivided earnings.

2.13 Credit unions use the funds from these shares and other members' savings accounts to make loans to members and to make investments. In general, loans to members make up the bulk of credit union assets. Funds not needed to meet member loan demand and operating expenses are invested.

Deregulation

2.14 Historically, credit unions have operated in a highly regulated environment in which regulations over interest rates on loans and share accounts significantly influenced operating activities. Legislation enacted in the early 1980s removed most restrictions on deposit instruments and enabled credit unions to compete more freely for deposits. To enhance member services and profitability, many credit unions have become much more aggressive in the areas of fees and charges, real estate, short-term construction, and business lending. These areas have the potential for higher earnings, but are much higher risk activities than traditional consumer lending.

2.15 As a result of these developments, some credit unions have experienced significant asset growth and have sometimes entered into higher risk transactions and activities, including aggressive lending, leveraged securities transactions, and acquisitions of complex financial instruments.

2.16 Occasional adverse effects from these transactions and activities have surfaced in the form of asset-quality and liquidity problems.

Credit Union System

2.17 Credit unions—through their state and national trade associations, service organizations, and corporate credit unions—make up the credit union system. Most credit unions are affiliated with the system through membership in their state credit union leagues. In turn, credit union leagues belong to the Credit Union National Association, Inc. (CUNA), the principal trade association for credit unions in the United States, while CUNA belongs to the World Council of Credit Unions, an international credit union organization. On the national level, for-profit affiliates of CUNA (including the CUNA Service Group, the CUNA Mutual Insurance Group, and the CUNA Mortgage Corporation) provide a wide variety of products and services to credit unions on a fee basis.

2.18 The National Association of State Credit Union Supervisors (NASCUS) was founded in 1965 and serves both state-chartered credit unions and the state credit union regulators who supervise them. Currently, there are over 3,543 State Credit Unions (including US territories) represented by NASCUS. NASCUS promotes a dual-chartering system and the advancement of the autonomy and expertise of state credit union regulatory agencies.

2.19 Credit unions also have their own financial system, the Corporate Credit Union Network, consisting of the U.S. Central Credit Union (U.S. Central) and its member corporate credit unions. These state or regional corporate credit unions make available a wide range of investments and correspondent financial services for credit unions.

2.20 Other national credit union associations include the National Association of Federal Credit Unions (NAFCU), the Credit Union Executives Society (CUES), and other associations serving similar credit unions such as educational, defense-related, or aerospace credit unions. These groups may also provide such services as supplies, marketing, insurance, fund transfers, and investment instruments through their affiliates.

Corporate Credit Union Network

2.21 U.S. Central serves as a financial intermediary for corporate credit unions. A corporate credit union is defined as a credit union organized by credit unions to offer central deposit and lending facilities for credit unions. In this role, the primary purpose of U.S. Central is to meet the corporate credit unions' short-term and long-term liquidity needs by maintaining access to public and private capital markets and providing loans to them. U.S. Central also offers a variety of investment opportunities for corporate credit union's excess liquidity. It also provides payment, settlement, safekeeping, accounting, correspondent, and information services to corporate credit unions. Lines of credit provided by U.S. Central to corporate credit unions consist of both advised and committed lines of credit facilities.

2.22 Corporate credit unions provide services to their member credit unions that are similar to those provided by U.S. Central to the corporate credit unions. In addition to the types of services offered to corporate credit unions by U.S. Central, corporate credit unions provide additional services to member credit unions. These additional services include but are not limited to investment alternatives, other liquidity services, coin and currency delivery, and check clearing for the share draft processing.

2.23 Although a few corporate credit unions service member credit unions in areas limited to the corporate credit unions' home state or a region, the majority of corporate credit unions have national fields of membership that cover states nationwide. Some also cover certain United States territories.

Regulation and Oversight

Government Supervision

2.24 Credit unions operate under either a federal or state charter and therefore are subject to government supervision and regulation, including periodic examinations by supervisory agency examiners. Federally chartered credit unions are supervised by the NCUA, which is also responsible for administering the NCUSIF. The NCUSIF provides share insurance to all federal credit unions and federally insured, state-chartered credit unions, and insures each deposit up to a specified amount. Each federally insured credit union is required to maintain a deposit with the NCUSIF in an amount equal to 1 percent of its total insured shares.

2.25 State-chartered credit unions are supervised by the regulatory agency of the chartering state. Most state-chartered credit unions are required to obtain NCUSIF share insurance coverage. A few credit unions obtain insurance from other sources that are sponsored by a private insurer. Participation in an insurance program is mandatory for most credit unions.

2.26 Credit unions are subject to the federal, state, and local laws applicable to financial institutions in general. Such laws include the Uniform Commercial Code (UCC), the Truth-in-Lending Laws, the Uniform Consumer Code, Truth-in-Savings regulations, and various federal and state tax codes. As financial institutions, they are also subject to a wide variety of federal regulations issued by such agencies as the Treasury Department, the Federal Reserve Board (FRB), and the Internal Revenue Service (IRS). Rules and regulations issued by the federal and state regulatory agencies address such issues as accounting practices, qualifications for membership, interest rate controls, permissible investments, consumer-protection issues, liquidity reserves, and other operational aspects. The Sarbanes-Oxley Act and the SEC implementing regulations do not specifically apply to federal credit unions. However, the NCUA issued Letter to Federal Credit Unions 03-FCU-07 in October, 2003 to provide a summary of certain provisions within the Sarbanes-Oxley Act that NCUA believes an FCU may wish to consider.

National Credit Union Administration

2.27 Approximately 60 percent of all credit unions are federally chartered by the NCUA, which issues regulations for both federal credit unions and federally insured, state-chartered credit unions. Federally insured, state-chartered credit unions sign an insurance agreement with the NCUA when they secure federal insurance that stipulates the regulations by which they agree to be bound. NCUA publications that provide useful background information to credit union auditors include the following:

- *Accounting Manual for Federal Credit Unions* (and interim *Accounting Bulletins*)
- *Supervisory Committee Manual for Federal Credit Unions*
- *National Credit Union Administration Rules and Regulations* (and periodic updates)
- *The Federal Credit Union Act*
- *The Federal Credit Union Handbook*
- *Federal Credit Union Manual of Laws*
- *FFIEC Information Systems Manual*
- *NCUA Chartering and Field of Membership Manual*
- *NCUA Examiner's Guide*

The *Accounting Manual for Federal Credit Unions* had the force of NCUA regulatory authority until 1981, when, except for section 2000 on basic accounting policies and procedures, it was deregulated. The most recent update of the November 2001 manual provides guidance for credit unions with assets under $10 million for the purposes of reporting to the NCUA Board. Those credit unions are not required to file reports in compliance with GAAP because of their size.

Regulatory Capital Matters

Natural Person Credit Unions

Capital Adequacy

2.28 The CUMAA was signed into law on August 7, 1998. Title III of this Act established a new system of tiered net worth requirements for all insured credit unions other than corporate credit unions. These requirements did not take effect until August 2000. The Act requires that the NCUA establish a net worth standard for insured credit unions as well as risk-based capital standards for complex credit unions as defined by the NCUA. A separate system of PCA is mandated for new credit unions. A *new credit union* is defined as a federally insured credit union that both has been in operation for less than ten years and has $10 million or less in total assets. A summary of general requirements follows. In 2000, the NCUA published PCA guidelines in the *Federal Register* effective August 7, 2000. On July 20, 2000, the NCUA published PCA guidelines with respect to the risk-based net worth requirement (RBNWR) effective January 1, 2001. Specific requirements are set forth in section 12 of the Code of Federal Regulations (CFR), Parts 700, 702, 741, and 747.

2.29 Under the net worth standard, a credit union's net worth, the numerator of the net worth ratio, is defined as retained earnings as determined under GAAP.[1]

2.30 A credit union's total assets, the denominator of the net worth ratio, is calculated in any one of four methods. It may be (1) the average of the quarter-end balances of the four most recent quarters, (2) the monthly average over the quarter, (3) the daily average over the quarter, or (4) the quarter-end balance. A credit union may elect a method from the four options to apply for each quarter. Whatever method is chosen for a quarter must be used consistently for all PCA measures other than the RBNWR.

2.31 Credit unions with less than 7 percent net worth with respect to total assets and any complex credit union, as defined below, not meeting risk-based standards will be required to increase net worth quarterly by an amount of earnings equivalent to at least 1/10 percent (0.1 percent) of total assets for the current quarter. Earnings are required to be transferred quarterly from current earnings to the statutory (regular) reserve. Not all states that have state-chartered credit unions permit this transfer. As in some states, legislation may be necessary to enact change. Separate calculations may also be required for state-chartered credit unions subject to state-imposed capital requirements and may be significantly different from the federal requirements.

Prompt Corrective Action (PCA)

2.32 In 1998, Congress amended the FCUA to require the NCUA Board to adopt a system of PCA to be applied to federally insured credit unions that become undercapitalized. The new FCUA provision imposes a series of progressively more stringent restrictions and requirements indexed to five net worth categories. The provision also mandates a separate system for new credit unions and additional RBNWRs for complex credit unions. Part 702 of the NCUA's Rules and Regulations provides details of the system of PCA.

2.33 A credit union is defined as *complex* and a RBNWR is applicable only if the credit union meets both of the following criteria as reflected in its most recent call report:

- The credit union's quarter-end total assets exceed $10 million.
- The credit union's RBNWR exceed 6 percent.

2.34 Under the PCA regulations of the NCUA, a credit union is classified in a net worth category as follows:

a. *Well capitalized* if it has a net worth ratio of 7 percent or greater and also meets any applicable RBNWR.

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[1] In reaction to FASB projects on business combination projects (for example FASB Statement No. 141, *Business Combinations*), Congress has proposed a new law, the Net Worth Amendment for Credit Unions Act, which would change the definition of Net Worth to include premerger retained earnings. (Reviewers who are credit union experts should confirm the status, that is, final legislation.)

b. *Adequately capitalized* if it has a net worth ratio of six percent or more but less than seven percent and meets any applicable RBNWRs.

c. *Undercapitalized* if it has a net worth ratio of four percent or more but less than six percent or fails to meet any applicable RBNWR.

d. *Significantly undercapitalized* if it:

   (1) Has a net worth ratio of two percent or more but less than four percent, or

   (2) Has a net worth ratio of four percent or more but less than five percent and either:

      (a) Fails to submit an acceptable net worth restoration plan within the time prescribed, or

      (b) Materially fails to implement a net worth restoration plan approved by the NCUA Board.

e. *Critically undercapitalized* if it has a net worth ratio of less than 2 percent.

Exhibit 2-1

Net Worth Classifications

Classification	*Net Worth Ratio*	*Prompt Corrective Action*
Well Capitalized	7% or greater	None
Adequately Capitalized	> 6% but < 7%	Earnings transfer
Undercapitalized—First tier	> 5% but < 6%	Mandatory for level
Undercapitalized—Second tier	> 4% but < 5%	Mandatory and discretionary for level
Significantly undercapitalized	Either *a.* > 2% but < 4% *b.* or > 4% but < 5% and either: (1) Fails to submit an acceptable net worth restoration plan; or (2) Materially fails to implement a restoration plan approved by the NCUA Board.	Mandatory and discretionary for level
Critically undercapitalized	< 2%	Mandatory and discretionary for level

2.35 Determining the net worth category of a credit union (other than a new credit union) is a multiple-step process. In the first step, an initial net worth category is determined by calculating the ratio of the credit union's net worth (under GAAP, excluding such factors as "accumulated other comprehensive income") to total assets (computed under any of the four methods described above). This ratio determines an initial category based on the following:

a. *Well capitalized* if it has a net worth ratio of seven percent or greater.

b. *Adequately capitalized* if it has a net worth ratio of six percent or more but less than seven percent.

c. *Undercapitalized* if it has a net worth ratio of four percent or more but less than six percent.

d. *Significantly undercapitalized* if it:

   (1) Has a net worth ratio of two percent or more but less than four percent, or

   (2) Has a net worth ratio of four percent or more but less than five percent and either:

      (*a*) Fails to submit an acceptable net worth restoration plan within the time prescribed, or

      (*b*) Materially fails to implement a net worth restoration plan approved by the NCUA Board.

e. *Critically undercapitalized* if it has a net worth ratio of less than 2 percent.

2.36 In the second step, the credit union (other than credit unions with less than $10 million in total assets at quarter-end) determines its RBNWR. If the RBNWR is less than 6 percent, the credit union does not have to meet a RBNWR and the credit union's initial net worth category would become its net worth classification under the PCA regulations. If the RBNWR is greater than 6 percent, but less than the credit union's actual net worth ratio, the credit union would meet its RBNWR and the credit union's initial net worth category would become its net worth classification under the PCA regulations. However, a credit union's net worth category may be downgraded if any supervisory or safety and soundness issues exist between the credit union and the NCUA or any applicable state regulatory authority.

2.37 For a credit union with an initial net worth category of either "well capitalized" or "adequately capitalized," but with an RBNWR that is greater than the initial net worth calculation if not met, the actual net worth classification under PCA regulations would be reduced to the first tier of "undercapitalized." For a credit union with an initial net worth category of "undercapitalized" or lower, any net worth restoration plan submitted by the credit union would have to consider the RBNWR if that requirement were greater than 6 percent.

2.38 The RBNWR is computed by multiplying the end-of-quarter balances of the credit union's risk-portfolio components (as defined in the regulations) by prescribed percentages (the *standard calculation*). If the standard calculation produces a RBNWR that is larger than the credit union's net worth ratio, the credit union can recalculate its RBNWR using some or all of the *alternative components approach*. In the alternative components approach, the maturities of several of the risk-portfolio components are used to produce a more detailed set of calculations, again each with a prescribed risk percentage. If the alternative components approach produces a RBNWR that is less than the credit union's net worth ratio, the credit union would have met its RBNWR. If the alternative components approach produces a RBNWR that is larger than the credit union's net worth ratio, the credit union may apply to the NCUA for a *risk mitigation credit* (explained below) to reduce its calculated RBNWR. If the credit union fails to obtain an adequate amount of risk mitigation credit to reduce its RBNWR below its net worth ratio, it would have failed its RBNWR. The RBNWR ratio is the sum of all components for each category at the calculation date.

2.39 As noted above, a credit union that fails to meet its applicable RBNWR using both the standard and alternative calculations may apply to the NCUA Board for a risk mitigation credit against the credit union's RBNWR. A risk mitigation credit may be granted by the NCUA Board based upon proof from the credit union of mitigation of credit risk or interest rate risk. The amount of the credit and the period for which the credit can be used by the credit union is up to the discretion of the NCUA Board. A risk mitigation credit may be denied based on the information presented by the credit union or based on other subjective factors considered by the Board of the NCUA. A risk mitigation credit may be withdrawn by the NCUA Board at any time.

2.40 Beyond the net worth and RBNWR related actions noted above, the NCUA Board may reclassify a well-capitalized credit union as adequately capitalized and may require an adequately capitalized or undercapitalized credit union to comply with certain mandatory or discretionary supervisory actions as if it were in the next lower net worth category in the following circumstances:

- The NCUA Board determines that the credit union is in an unsafe or unsound condition; or
- The NCUA Board determines that the credit union has not corrected a material unsafe and unsound practice of which it was, or should have been, aware.

2.41 Actions that may be taken under the PCA provisions can include both mandatory and discretionary actions for each level of capitalization below well capitalized. Actions can range from setting earnings aside to build net worth to restricting or prohibiting certain activities.

2.42 Credit unions classified as undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a net worth restoration plan for restoring the credit union to adequate capitalization. Among other things, the plan should:

- Specify a quarterly timetable of steps the credit union will take to become adequately capitalized.
- Contain a specific timetable for increasing net worth for each quarter of the plan.
- Specify the amount of earnings equivalent the credit union will transfer to its reserve account on a quarterly basis.
- Detail how the credit union will comply with other restrictions or requirements put into effect.
- Set forth the types and levels of activities in which the union will engage.
- Include pro forma statements covering the next two years at a minimum.

2.43 Under the FCUA, a *new* credit union is classified as:

a. *Well capitalized* if it has a net worth ratio of seven percent or greater and also meets any applicable RBNWR.

b. *Adequately capitalized* if it has a net worth ratio of six percent or more but less than seven percent and meets any applicable RBNWRs.

c. *Moderately capitalized* if it has a net worth ratio of three and one half percent or more but less than six percent, or fails to meet any applicable RBNWR.

d. *Marginally capitalized* if it has a net worth ratio of two percent or more but less than three and one half percent.

e. *Minimally capitalized* if it has a net worth ratio of zero percent or greater but less than two percent.

f. *Undercapitalized* if it has a net worth of less than zero percent.

2.44 The NCUA Board may reclassify a well capitalized, moderately capitalized, or marginally capitalized new credit union to the next lower net worth category if they determine the credit union is in an unsafe or unsound condition, or the credit union has not corrected a material unsafe or unsound condition.

2.45 New credit unions classified as moderately, marginally, minimally, or undercapitalized must file a revised business plan. At a minimum, the revised business plan must:

- Outline steps the credit union will take to become adequately capitalized.
- Set specific quarterly targets for increasing net worth for each year of the plan.
- Set forth the amount of earnings equivalent the credit union will transfer to its reserve account.
- Detail how the credit union will comply with other restrictions or requirements put into effect.

2.46 Actions that may be taken under the PCA provisions for new credit unions include both mandatory and discretionary actions ranging from the restriction or prohibition of certain activities to the appointment of a receiver or conservator of the credit union's net assets.

Notice and Effective Date of Net Worth Classification

2.47 A federally-insured credit union shall have notice of its net worth ratio (including any applicable RBNWR) and shall be classified within the corresponding net worth category as of the earliest to occur of the following:

- The last day of the calendar month following the end of the calendar quarter
- The date the credit union's net worth ratio is recalculated by or as a result of its most recent final report of examination
- The date the credit union received written notice from the NCUA Board or, if state-chartered, the appropriate state official, of reclassification based on safety and soundness grounds

2.48 A federally-insured credit union that files its call reports semiannually must give written notice to the NCUA Board and, if state-chartered, to the appropriate state official, of a change in its net worth ratio for the quarters ending March 31 and September 30, if that change places the credit union in a lower net worth category. Credit unions are required to notify the NCUA Board and, if state-chartered, the appropriate state official, of a change in its net worth ratio that places the credit union in a lower net worth category no later than 15 calendar days after the effective date of the change. Written notice to the NCUA Board shall be deemed effective if it is delivered to the appropriate regional director and, if state-chartered, to the appropriate state official. Failure to provide such notice to the NCUA Board within 15 calendar days, or failure to provide such notice altogether, in no way alters the effective date of a change of net worth classification, nor the affected credit union's legal obligations.[2]

2.49 Noncompliance or expected noncompliance with regulatory net worth requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the PCA provisions warrants similar attention by independent accountants when considering an institution's ability to remain a going concern. In addition, when a credit union has met its RBNWR through the use of a risk mitigation credit, the subjectivity involved in granting and maintaining the credit may also warrant attention by independent accountants.

Corporate Credit Unions

2.50 Corporate credit unions have regulatory capital requirements that are different from those of other credit unions. Corporate credit unions are not covered by the net worth requirements applicable to other credit unions by virtue of the CUMAA. By statute, the equity or capital of a corporate credit union consists of all of its shares, reserves, and undivided earnings. The NCUA has established a regulatory capital requirement applicable to all corporate credit unions. A state-chartered corporate credit union is also subject to its applicable state law capital requirement, if any. For NCUA regulatory purposes, corporate credit union capital consists of the sum of the corporate credit union's reserves and undivided earnings, paid-in capital, and membership capital. Paid-in capital and membership capital are typically different types of subordinated share accounts.

2.51 For NCUA purposes, a corporate credit union is required to maintain a monthly minimum capital ratio of four percent. The capital ratio is determined by dividing the corporate credit union's capital by the moving daily average net assets (MDANA). MDANA is defined in Section 704.2 of NCUA Rules and Regulations as the average of daily average net assets for the month being measured and the previous eleven months. Net assets are defined in section 704.2 of NCUA's Rules and Regulations as total assets less various specified types of assets.

2.52 If a corporate credit union's prior month-end retained earnings ratio is less than 2 percent, it is subject to the earnings retention requirements of Section 704.3(i) of the Corporate Rule. If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or if the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum.

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[2] Readers may refer to the NCUA Rules and Regulations part 741.6(a) for additional information.

2.53 The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets. The quarterly earnings retention amount is determined by multiplying the earnings retention factor by the moving daily average net assets for each of the prior three month-ends.

2.54 The minimum retained earnings ratio, core capital ratio, and related earnings retention requirements for wholesale corporate credit unions are outlined in Section 704.19 of the Final Rule.

2.55 NCUA may also establish different minimum capital and/or retained earnings ratio requirements for an individual corporate credit union based on its circumstances.

Annual Audits*

2.56 As discussed in paragraph 2.05, CUMAA requires:

a. All federally insured credit unions with assets of $500 million or more to obtain an annual independent audit of their financial statements by a certified public accountant or licensed public accountant.

b. All federally insured credit unions with assets of $10 million or more must follow GAAP for all reports or statements required to be filed with the NCUA Board and obtain one of the following four services:

(1) If the credit union is federally insured with assets of $500 million or more, the opinion audit must be performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.

(2) If the credit union is federally chartered with assets of more than $10 million but less than $500 million, the credit union has four options:

(*a*) Follow the requirement in item (1) above.

(*b*) Obtain an opinion audit on the credit union's balance sheet performed by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.

(*c*) Obtain an examination of management's assertions regarding internal controls over call reporting conducted by an independent accountant licensed by the state or jurisdiction in which the audit is conducted.

* NCUA issued an Advance Notice of Proposed Rulemaking (ANPR), *Supervisory Committee Audits*. The ANPR was posted in the *Federal Register* on February 23, 2006 (Vol. 71, No. 36) and the comment period closed April 24, 2006. The release seeks comment on whether and how to modify its Supervisory Committee audit rules to require credit unions to obtain an "attestation on internal controls" in connection with their annual audits; to identify and impose assessment and attestation standards for such engagements; to impose minimum qualifications for Supervisory Committee members; and to identify and impose a standard for the independence required of State-licensed, compensated auditors. For the internal control over financial reporting engagement, the release presumes no asset threshold but refers to the FDIC's existing requirements under FDICIA.

(*d*) Obtain a supervisory committee audit that meets the minimum requirements of the Supervisory Committee Guide.

2.57 For any federal credit union with assets of more than $10 million that uses an independent accountant who is compensated for his services, the audit is subject to state accounting laws, including licensing requirements.

2.58 Although GAAP basis accounting is not required for internal reporting, GAAP is required for call reports filed with the NCUA Board for credit unions with assets of $10 million or more.[3] As most auditors typically perform financial statement audits at a quarter-end and credit unions are required to file quarterly call reports, the independent accountant should have GAAP-based financial statements to work with in connection with his audit.

2.59 The minimum requirements for a supervisory committee audit of federally chartered credit unions are prescribed by Part 715 of the NCUA Rules and Regulations. State-chartered credit unions are subject to the audit requirements established by state regulatory agencies if they are more stringent than Part 715 requirements. To satisfy regulatory requirements for a supervisory committee audit, the supervisory committee may perform the required procedures itself or it may engage an independent accountant to perform procedures that are necessary to fulfill the federal or state requirements. Because the types of engagement can differ so significantly, it is important for the independent accountant to establish a clear understanding of the nature of an engagement to perform a supervisory committee audit.

2.60 Effective October 21, 2005, the NCUA amended its rule requiring credit union service organizations to obtain a separate financial statement audit from a CPA if it is included in the annual consolidated audit of a federal credit union. This amends section 12 of CFR, Part 712. GAAP calls for the preparation of financial statements of both the NAFCU and the CUSO on a consolidated basis (www.ncua.gov).

Other Reporting Considerations

2.61 The independent accountant may be requested to perform assurance services other than those required by CUMAA to the extent that a credit union may be:

a. Originating or holding student loans
b. Servicing residential mortgage loans for others
c. Borrowing from a district Federal Home Loan Bank
d. Participating in an automated-teller-machine (ATM) Network
e. Originating or receiving automated-clearinghouse (ACH) transactions
f. Using outside technology partners
g. Subject to the provisions of the Bank Secrecy Act (BSA)

[3] Readers may refer to the NCUA Rules and Regulations part 741.6(b) for additional information.

Chapter 3

Industry Overview—Finance Companies[1]

Description of Business

3.01 Finance companies provide lending and financing services to consumers (consumer financing) and to business enterprises (commercial financing). A number of finance companies engage solely in consumer or commercial financing activities; others provide both types.

3.02 Manufacturers, retailers, wholesalers, and various other business enterprises may provide financing to encourage customers to buy their products and services. Such financing, generally known as *captive finance activity*, may be provided directly by those companies or through affiliated companies. Although most such companies, originally financed only their own products and services, many have expanded their financing activities to include a wide variety of products and services sold by unaffiliated businesses.

3.03 Consumer finance activities comprise direct consumer loans, including mortgage loans and retail sales financing. Many companies that provide consumer financing also offer a variety of insurance services to their borrowers.

3.04 ***Insurance Services.*** Many companies engaged in consumer finance activities also offer insurance coverage to their customers. Such coverage may include life insurance to repay remaining loan balances if borrowers die; accident and health insurance to continue loan payments if borrowers become sick or disabled for an extended period of time; and property insurance to protect the values of loan collateral against damage, theft, or destruction. Some lenders may provide insurance through subsidiaries. Others act as brokers and, if licensed, often receive commissions from independent insurers. Lenders also may receive retrospective rate credits on group policies issued by independent insurers. In still other instances, policies may be written by independent insurance companies and then reinsured by the insurance subsidiaries of finance companies.

3.05 Commercial finance enterprises often provide a wide range of services, including factoring arrangements, revolving loans, installment and term loans, floor plan loans, portfolio purchase agreements, and lease financing to a variety of clients, including manufacturers, wholesalers, retailers, and service organizations. Many commercial finance activities are called *asset-based financial services* because of the lenders' reliance on collateral.

3.06 Commercial loans generally are collateralized by various types of assets, including notes and accounts receivable; inventories; and property, plant, and equipment.

3.07 Increased competition has come from within the industry, but also from nontraditional players such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial enterprises.

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[1] This Guide covers entities under paragraph 3(*b*) of SOP 01-6 (i.e., entities that have trade receivables) in addition to independent and captive finance companies.

These entities now do business directly with potential customers in transactions traditionally executed through finance companies. This disintermediation has increased the need for innovative approaches to attracting customers. It has also led to an increased need for more complex financing structures such as use of tax oriented vehicles, the ability to offer longer term financing than traditional banks, and a higher level of asset knowledge to take more aggressive residual positions and collateral risk.

Debt Financing

3.08 The basic activity of finance companies is borrowing money at wholesale interest rates and lending at a markup. Strong credit ratings foster the ability to attract wholesale funds at a competitive cost. Accordingly, in order to qualify for high ratings, it is common for finance companies to structure financing transactions according to predetermined rating agency credit criteria. A credit rating represents a measure of the general creditworthiness of an obligor with respect to a particular debt security or financial obligation, based on relevant risk factors. Over the years, the credit ratings from rating agencies such as Standard and Poor's Rating Services, Duff & Phelps Credit Rating Co., Moody's Investor Service, Inc., and Fitch IBCA, Inc. have achieved wide acceptance as easily usable tools for differentiating credit quality.

3.09 Unlike most depository institutions, finance companies typically do not utilize customer deposits as a significant source of funding. Accordingly, access to a variety of funding sources is vital to market access, liquidity, and funding cost effectiveness. Typical short-term funding sources include commercial paper and bank credit facilities. Senior debt, senior subordinated debt, and junior subordinated debt are typical medium to long-term funding sources. It is common for these types of funding sources to contain restrictive covenants.

3.10 Securitization is often utilized by finance companies to diversify funding sources. In some markets, securitization has reduced entry barriers and increased competition. Securitization involves the sale, generally to a trust, of a portfolio of loan receivables. Asset-backed certificates are then sold by the trust to investors through a private placement or public offering. Typically, the finance company will retain the servicing rights for the loans sold to the trust. A subordinated interest in the trust is also typically retained by the finance company, serving as a credit enhancement to the asset-backed certificates. Such structures provide the opportunity for less credit worthy companies to obtain funding at competitive levels through the asset backed and other structural characteristics of securitization vehicles.

3.11 Robert Morris Associates, an organization of bank lending officers, has developed financial information questionnaires for lenders engaged in retail sales financing, direct cash lending, commercial financing, captive financing activities, and mortgage banking. Finance companies generally complete and submit the questionnaires to credit grantors as an integral part of the process of obtaining credit lines with commercial banks and other lenders. The information is used to analyze the quality of the operations and creditworthiness of finance companies.

Regulation and Oversight

3.12 Publicly held finance companies are generally subject to requirements of federal securities laws, including the Securities Act of 1933 (the

1933 Act), the Securities Exchange Act of 1934 (the Exchange Act), and the Sarbanes-Oxley Act of 2002. Companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the SEC.

3.13 Numerous state and federal statutes affect finance companies' operations. Some statutes apply only to specific types of activities. Regulations affecting finance companies generally are limited to matters such as loan amounts, repayment terms, interest rates, and collateral; they generally do not address financial accounting and reporting. Certain of the more significant state and federal laws related to consumer lending are discussed in Chapter 8, "Loans."

Chapter 4

Industry Overview—Mortgage Companies

Description of Business

4.01 As a result of the relative imbalance between the supply and demand for residential mortgage funds, mortgage banking enterprises play an integral role in providing mortgage capital in the amounts needed and in the geographic locations required to meet the housing needs of the general public. The market whereby mortgage funds are disseminated to areas other than their originating, or primary, market is referred to as the secondary market.

4.02 The principal participants in the secondary market for residential financing are government-sponsored enterprises (GSEs), such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Also active in the secondary market are federal agencies such as the Government National Mortgage Association (GNMA, also known as Ginnie Mae) and the Department of Veterans' Affairs (VA). These entities participate in the secondary market as issuers, investors, or guarantors of asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), real estate mortgage investment conduits (REMICs), and collateralized mortgage obligations (CMOs). Many private entities are also active in the secondary market as issuers and investors. (Chapter 7, "Investments in Debt and Equity Securities," describes ABS transactions and considerations for investors in ABSs.)

4.03 Freddie Mac and Fannie Mae primarily purchase conventional fixed- and variable-rate residential mortgage loans, while Ginnie Mae generally purchases pools of government-insured residential mortgage loans. Secondary market participants typically pool the loans that are purchased, securitize them into mortgage-backed securities (MBSs), and sell the securities in the secondary market.

4.04 Beginning in the early 1970s, secondary market activities for all mortgage lenders increased substantially as a result of the establishment of Freddie Mac and the new involvement of Fannie Mae and Freddie Mac with the conventional secondary market. Prior to that time, Fannie Mae was one of the few national secondary mortgage markets participants through its whole-loan purchase and sale programs related to government loans.

4.05 MBSs became more prominent with the creation of Ginnie Mae in 1968 and the subsequent issuance of the first GNMA pass-through securities. Nontraditional mortgage investors were more inclined to invest in GNMA pass-through securities as a result of government guarantees on both the underlying mortgage collateral and on the securities themselves. During this same time period, Freddie Mac began selling pass-through securities backed by conventional residential mortgages. By the mid 1970s, residential mortgages had been accepted as viable security collateral by the investment community.

4.06 Today, the securities markets play a significant role in the execution and pricing of residential mortgage securities, and handle an increasing volume of residential mortgage-backed transactions. As a result, securities markets influence mortgage pricing on a national scale and also influence the design of various mortgage products.

4.07 With the dominant role of the mortgage securities markets and economic changes throughout the mortgage lending industry, nontraditional participants in the secondary market (as opposed to the traditional thrift portfolio lenders) continue to evolve. Securities underwriters, commercial banks, insurance companies, and nonfinancial corporate entities, are playing a part in mortgage banking. In addition, mortgage lending entities are securitizing other types of loan products, such as sub-prime loans and home equity lines of credit.

4.08 In 1997, the Federal Home Loan Bank of Chicago began the Mortgage Partnership Finance (MPF) Program. The MPF Program is available through most Federal Home Loan Banks (FHLBs) and provides member financial institutions an alternative method for funding home mortgages for their customers. Under the MPF Program, the lender effectively originates loans for, or sells loans to, the respective FHLB. The lender retains the credit risk and customer relationship (through servicing) inherent in the loan, and shifts the interest rate risk and prepayment risk to the FHLB. The lender receives a credit enhancement fee from the FHLB in exchange for managing the credit risk of the loan. Effectively, the FHLBs have offered an alternative funding strategy to the traditional secondary mortgage market.

4.09 Many mortgage banking enterprises are subsidiaries of banks or bank holding companies. Mortgage banking is generally compatible with a bank's financing operations, and the bank is an obvious resource for the mortgage banking entity's financing requirements. A mortgage banker typically requires a warehouse line of credit, whereby mortgage loans are funded by advances from the credit line, and are "warehoused" in the portfolio as security for the credit line until it is paid down through the subsequent sale of the mortgage loan into the secondary market. The interest margin at which a mortgage banker can fund its operations and extend mortgage financing is critical to the financial success of the entity.

4.10 In turn, access to the secondary mortgage market is an important source of liquidity for banks and savings institutions. Many institutions have deposit bases that are keyed to variable rates and, therefore, are particularly sensitive to interest-rate risk. A variable-rate deposit base cannot fund long-term, fixed-rate assets without creating significant loss exposure in rising interest-rate environments. Therefore, sales of mortgage loans and servicing rights in the secondary market and the accompanying gains and losses and the creation of income streams from servicing and other fees are an important source of funds to many institutions. Access to the secondary market also provides opportunities to restructure existing long-term portfolios.

4.11 Mortgage banking activities primarily consist of two separate but interrelated activities, namely, (*a*) the origination or acquisition of mortgage loans for the purpose of selling those loans to permanent investors in the secondary market, and (*b*) the subsequent servicing of those loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including in-house origination and purchases from third-party correspondents.

4.12 Residential mortgage loans may be sold to investors with or without the right to service such loans. Servicing offers an entity additional, and potentially significant, sources of income in the form of servicing fees, late-charge fees, float earnings, and numerous other ancillary fees. Servicing fees are typically expressed as a percentage of the outstanding loan principal balance, such as 0.25 percent or 25 basis points.

4.13 The servicing function includes collecting payments from borrowers, transmitting insurance and tax payments to the related recipients, remitting payments to investors, performing the collection function for delinquent loans, and initiating foreclosure proceedings. The precise nature of the servicing function is dependent on the specific requirements of the investor.

4.14 The servicing rights attributable to a mortgage portfolio are generally viewed as a primary asset of a mortgage banking enterprise. The value of the servicing asset is a function of the anticipated life of the servicing right (how long the loan is expected to be outstanding and serviced) and the estimated net servicing revenues attributable to the servicing function. As a result of an active market for the purchase and sale of loan servicing rights, there is a certain degree of liquidity to servicing rights. Conversely, servicing portfolios are subject to significant impairment risk as unanticipated periods of rapid prepayments can cause substantial declines in the value of the servicing asset. Accordingly, the assumptions upon which the value of servicing transactions are based are critical to the financial performance of the servicing entity. Refer to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,[1] for accounting requirements relating to servicing rights. See paragraph 4.20 below for important regulatory guidance about servicing assets.

4.15 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140.* The Statement amends paragraphs 35(c) and 40 of FASB Statement No. 140. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

4.16 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140.* Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

4.17 The magnitude of interest-rate movements and the speed with which they can occur make risk management in a mortgage banking enterprise complex and difficult. Strategies and operating plans are required to monitor and control the risk exposure of mortgage banking operations, as well as sophisticated reporting systems that provide the information needed to carry out the plans and strategies.

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[1] FASB has issued a related exposure draft, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140, which is scheduled to be in the second quarter of 2007. Readers are advised to monitor developments.

4.18 In addition to the interest-rate risk inherent in an entity's mortgage loan pipeline (the inventory of loans in various stages of process), an entity may be subject to recourse risk. Recourse risk is the risk that an investor may either reject a loan or require the mortgage lender to repurchase the loan if there is a defect in underwriting or documentation, or if the loan becomes delinquent within a specified amount of time after purchase. This risk varies based on the terms of the sale and servicing agreement with each investor.

4.19 Mortgage banking is a complex financial services business requiring analytical skills and financial modeling and forecasting abilities. The required level of computer systems support for mortgage banking operations is significant. Access to accurate data that are instantly available is paramount in managing the risks of mortgage banking. The resources required to compete effectively have made it difficult for the small, independent firm to survive, and the medium to large-size mortgage banking operations are often subsidiaries of larger institutions, both financial and nonfinancial.

Regulation and Oversight

4.20 Publicly held mortgage companies are generally subject to requirements of federal securities laws, including the 1933 Act and the Exchange Act and the Sarbanes-Oxley Act of 2002. Companies whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC).

4.21 Virtually all states have enacted laws governing the conduct of mortgage lenders and mortgage services, and have created regulatory bodies to oversee the industry. The majority of all jurisdictions have licensing requirements for mortgage brokering, lending, and servicing. The scope of these requirements can vary significantly. Certain states simply require that an entity register with a state before participating in a certain mortgage-related activity. Others require compliance with strict regulations concerning recordkeeping, office location, accounting, and origination and servicing procedures.

4.22 The mortgage lending process is regulated by both state and federal law. Regulations are generally designed to protect the consumer from unfair lending practices, and noncompliance with the regulations may result in financial liability, including the imposition of civil money penalties and reimbursements to the borrower, where applicable. Certain of the more significant regulations are discussed in Chapter 8, "Loans." On February 25, 2003, the OCC, FDIC, FRB, and OTS issued "Interagency Advisory on Mortgage Banking." This important document discusses examination concerns about the valuation and modeling of servicing assets and discusses the need to determine if an impaired servicing asset should be written off. In May 2005, the OCC, FDIC, FRB, OTS and NCUA issued "Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans." This advisory provides guidance related to the origination of mortgage loans that will be held for resale, and the sale of mortgage loans under mandatory delivery and best efforts contracts.

4.23 In addition, in connection with various lending programs that a mortgage lender may be involved in, specific program requirements may be applicable. Certain common requirements are discussed in the following paragraphs.

4.24 U.S. Department of Housing and Urban Development (HUD) sponsors a broad range of programs designed to revitalize urban neighborhoods, stimulate housing construction, encourage home ownership opportunities, and provide safe and affordable housing. The programs are carried out through various forms of federal financial assistance, including direct loans and mortgage insurance. The Federal Housing Administration (FHA) was established by Congress in 1934 and is part of HUD. The FHA was created to encourage lenders to make residential mortgage loans by providing mortgage insurance. To participate in the FHA mortgage insurance program, a mortgage lender must obtain HUD approval by meeting various requirements prescribed by HUD, including maintaining minimum net worth requirements. Net worth requirements vary depending on the program.

4.25 To obtain approval to sell and service mortgage loans for Fannie Mae and/or Freddie Mac, a mortgage lender must meet various requirements including maintaining an acceptable net worth. Upon approval, a mortgage lender enters into a selling and servicing contract and must comply with the terms of the respective selling and servicing guides, which set forth detailed requirements regarding underwriting, mortgage delivery, and servicing.

4.26 Ginnie Mae was created by Congress as part of HUD. Ginnie Mae's primary role is to guarantee MBSs issued by Ginnie Mae-approved lenders and backed principally by FHA-insured and VA-guaranteed loans. To obtain Ginnie Mae approval, a mortgage lender must be a HUD-approved lender and a Ginnie Mae- or Fannie Mae-approved mortgage servicer with experience necessary to issue and service MBSs. A mortgage lender must also meet net worth requirements prescribed by Ginnie Mae.

4.27 Mortgage lenders may also enter into agreements with private investors to sell and service mortgage loans. Such agreements set forth various standards applicable to the transaction and may include minimum financial or net worth requirements.

Reporting Considerations

HUD Programs

4.28 To participate in HUD programs, a *nonsupervised mortgagee* (a lender other than a financial institution that is a member of the Federal Reserve System or whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration) must comply with the requirements of the Consolidated Audit Guide for Audits of HUD Programs, issued by the HUD Office of Inspector General. The Guide requires that the engagement be performed in accordance with *Government Auditing Standards* and contains (*a*) suggested procedures for testing an entity's compliance with laws and regulations affecting HUD-assisted programs, (*b*) a requirement to test controls in all HUD-related audits, (*c*) the basic financial statements and types of supplementary information that must be presented with an entity's basic financial statements, and (*d*) an auditor's reporting responsibilities and illustrative reports on the basic financial statements and supplementary information, internal control, and compliance with laws and regulations.

4.29 In August 2002, HUD released the Final Uniform Financial Reporting Standards Rule (24 CFR Part 5) requiring electronic submission of the financial statement package required for annual mortgagee recertification. In order to ensure the integrity of this audited financial information, mortgagees' auditors are required to attest to the data electronically. Refer to HUD Mortgagee Letter 2003-03.

Residential Loan Servicing for Investors

4.30 Lenders that service residential mortgage loans for investors may be required to engage an independent accountant to provide assurance relating to management's written assertions about compliance with the minimum servicing standards set forth in the Uniform Single Attestation Program for Mortgage Bankers (USAP). This examination engagement is performed in accordance with Chapter 6, "Compliance Attestation," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT section 601). The USAP was developed by the Mortgage Bankers' Association of America and is intended to provide the minimum servicing standards with which an investor should expect a servicing entity to comply.

4.31 The SEC's final rule, Regulation AB,[2] codifies requirements for registration, disclosure, and reporting for all publicly registered asset-backed securities, including mortgage-backed securities, and is effective for most publicly registered transactions beginning January 1, 2006. Regulation AB requires the issuance of an "attestation report on assessment of compliance with servicing criteria for asset-backed securities" changes the required disclosures associated with the securities registration process, changes the reporting requirements for asset backed securities, and requires a new annual servicing assertion. The servicing criteria adopted as part of Item 1122 of Regulation AB, *Compliance With Applicable Servicing Criteria*, is consistent with the criteria in SSAE No. 10 and the audit procedures to be performed will largely be incremental to procedures already performed under the USAP.

[2] Readers may refer to the original rule issued Dec. 22, 2004: www.sec.gov/rules/final/33-8518.htm, and an amendment issued Nov. 29, 2005: www.sec.gov/rules/final/33-8518a.pdf.

Chapter 5

Audit Considerations and Certain Financial Reporting Matters[*], [1]

Overview

5.01 In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This section of the Guide provides guidance, primarily on the application of the standards of fieldwork. Specifically, this section provides guidance on the risk assessment process and general auditing considerations for deposit and lending institutions.

Planning and Other Auditing Considerations

5.02 The objective of an audit of a deposit and lending institution's financial statements is to express an opinion on whether its financial statements present fairly, in all material respects, its financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles (GAAP). To accomplish that objective, the independent accountant's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations, assessment of risks of material misstatement, and other auditing considerations relevant to deposit and lending institutions.

Audit Planning

5.03 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor, preliminary engagement activities, establishing an understanding with the client, preparing a detailed, written audit plan, determining the extent of involvement of professionals with specialized skills, and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of

[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards related to audits of issuers and non-issuers (see definitions in the Preface).

[1] This chapter has been conformed to the risk assessment standards (Statements on Auditing Standards (SAS) No. 104–111) where appropriate. SASs No. 104–111 are not applicable to issuers. Auditors of issuers should look at the AICPA publication entitled *PCAOB Standards and Related Rules* for guidance. Refer to the Preface for additional guidance including, the major differences between generally accepted auditing standards and final PCAOB standards approved by the Securities and Exchange Commission (SEC).

the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

5.04 The independent accountant's assessment of the risks of material of misstatement in an engagement affects staffing, the extent of supervision, overall audit scope and strategy, and the degree of professional skepticism applied. Financial institutions are subject to certain risks that are less prevalent in commercial, industrial, and other nonfinancial businesses, and they operate in a particularly volatile and highly regulated environment. Accordingly, the independent accountant should design appropriate overall responses to that higher risk with personnel who have appropriate relevant experience, providing more extensive supervision, and maintaining a heightened degree of professional skepticism. See paragraph 5.05 for more guidance regarding the auditor's overall responses to audit risk.

5.05 Paragraph .03 of AU section 311 states that the auditor must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

Scope of Services

5.06 The scope of services rendered by independent accountants generally depends on the types of reports to be issued as a result of the engagement. Early in the engagement, the independent accountant should establish a written understanding with the institution's management regarding the scope of services to be performed and the reports to be issued, which may include auditing the institution's financial statements. AU section 311 states that the understanding with the client should include the objectives of the engagement, the auditor's responsibilities and limitations of the engagement. If the accountant believes an understanding with the client has not been established, he or she may decline to accept or perform the engagement. The accountant may consider whether the engagements provide for the independent accountants' reports necessary to satisfy relevant regulatory requirements, such as those engagements described in Chapter 1, "Industry Overview—Banks and Savings Institutions,"paragraph 1.43, as well as any additional legal or contractual requirements, such as:

- Auditing the financial statements of common trust funds and applying agreed-upon procedures related to trust activities (Chapter 20, "Trust Services and Activities," includes a description of trust services and activities.)
- Reporting on management's assertions about compliance with the requirements of the Consolidated Audit Guide for Audits of Department of Housing and Urban Development (HUD) programs, compliance with the minimum servicing standards set forth in Uniform Single Audit Program for Mortgage Bankers (USAP), and compliance with servicing criteria for asset-backed securities as required by Regulation AB. (See Chapter 4, "Industry Overview—Mortgage Banking.")

- Applying minimum agreed-upon procedures to assist the supervisory committee in fulfilling its responsibilities (The scope of services are expanded beyond the minimum procedures. See Chapter 2, "Industry Overview—Credit Unions," and Chapter 22, "Reporting Considerations.")
- Reporting on management's assertions about compliance with certain Department of Education requirements relative to student loan activities. (See Chapter 1.)
- Reporting on the processing of transactions by banks and savings institutions or credit union service organizations (CUSOs) functioning as service organizations in accordance with AU section 324, Service Organizations (AICPA, *Professional Standards*, vol. 1).[2,3] (See Chapters 10, "Transfers of Loans and Mortgage Banking Activities;" 13, "Deposits;" and 20, "Trust Services and Activities," as they relate to loan servicing, deposits, and trust activities, respectively.)

Using the Work of a Specialist

5.07 AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance for independent accountants who use the work of a specialist in audits performed in accordance with GAAS.AU section 336 provides examples of situations that might require using the work of specialists and types of specialists being used, and guidance for when a specialist is related to the client.

5.08 AU section 336 applies whenever the independent accountant uses a specialist's work as audit evidence in performing substantive procedures to evaluate relevant assertions, regardless of whether:

- Management engages or employs specialists.
- Management engages a specialist employed by the independent accountant's firm to provide advisory services.
- The independent accountant engages the specialist.

5.09 AU section 336 does not apply if a specialist employed by the independent accountant's firm participates in the audit. For example, if the independent accountant's firm employs an appraiser and decides to use that appraiser as part of the audit team to evaluate the carrying value of properties, AU section 336 would not apply. In such cases, the independent accountant should refer to AU section 311.

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[2] When conducting an audit in accordance with PCAOB Standards, refer AU section 336, *Using the Work of a Specialist* and to paragraphs B18–B29 in Appendix B, of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") regarding the use of service organizations).

[3] The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forwardlooking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers. Readers should be aware of the guidance in this Guide.

5.10 AU section 336 requires an independent accountant to evaluate the professional qualifications of the specialist to determine whether he or she possesses the necessary skill or knowledge. AU section 336 requires the independent accountant to consider the specialist's experience and the type of work under consideration. For example, if the independent accountant is using an appraisal of commercial real estate values in connection with the audit of financial statements, he or she will need to consider not only the appraiser's professional qualifications but also his or her experience with commercial real estate.

5.11 The independent accountant should also understand the nature and purpose of the specialist's work. In a number of cases, the specialist's work may have been prepared for another purpose (such as, an appraiser's report prepared for a loan origination). In these situations, the independent accountant should consider the appropriateness of using the specialist's work to evaluate financial statement assertions. AU section 336 acknowledges that, in some cases, an independent accountant may need to contact the specialist to determine whether the specialist is aware that his or her work will be used for corroborating the assertions in the financial statements.

5.12 AU section 336 does not preclude the independent accountant from using a specialist who has a relationship with the client, including situations in which the client has the ability to directly or indirectly control or significantly influence the specialist. The Statement does, however, require the independent accountant to evaluate the relationship and consider whether it might impair the specialist's objectivity. If the independent accountant concludes that the specialist's objectivity might be impaired, additional procedures should be performed, possibly including using the work of another specialist.

5.13 The Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB) issued Auditing Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," in AU section 9336.01–.21, *Using the Work of a Specialist: Auditing Interpretations of Section 336* (AICPA, *Professional Standards*, vol. 1). The guidance relates to examples of legal opinions that auditors will need to obtain and review with regard to transfers of financial assets by banks subject to receivership or conservatorship under provisions of the Federal Deposit Insurance (FDI) Act. This Interpretation is for auditing procedures related to transfers of financial assets that are required to be accounted for under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.[4]

Audit Risk

5.14 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function

[4] The FASB has issued a related exposure draft, Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140 expected to be finalized in the first quarter of 2007. In November of 2005 the FASB staff issued FASB Staff Position (FSP) 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140.* This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

5.15 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risk of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. AU section 312.23 states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis to design and perform further audit procedures (tests of controls or substantive procedures). Defaulting to a maximum inherent or control risk assessment is not permitted.

5.16 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Planning Materiality

5.17 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

5.18 In accordance with paragraph .27 of AU section 312, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole.

Tolerable Misstatement

5.19 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. AU section 312.34 defines *tolerable misstatement (or tolerable error)* as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

5.20 As indicated above, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, a loan made to a related party of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

5.21 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Use of Assertions in Obtaining Audit Evidence

5.22 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.

Categories of Assertions—continued			
	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Under-standability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

5.23 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity and Its Environment, Including Its Internal Control

5.24 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirement and provides guidance about implementing the second standard of field work, as follows:

> "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error

or fraud, and to design the nature, timing, and extent of further audit procedures."

5.25 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).

Risk Assessment Procedures

5.26 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, and to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

5.27 In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- Inquiries of management and others within the entity
- Analytical procedures
- Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Analytical Procedures

5.28 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of analytical procedures in audits of financial statements and prescribes the use of analytical procedures in both risk assessment and review stages for such engagements. For risk assessment purposes, such procedures focus on (*a*) enhancing the independent accountant's understanding of the institution's business and transactions and events that have occurred since the last financial statement audit and (*b*) identifying areas that may present specific risks relevant to the financial statement audit. The objective of analytical procedures is to identify unusual transactions and events, and amounts, ratios, and trends that might indicate matters that may affect the risks of material misstatement.

5.29 Analytical procedures used in risk assessment generally use data aggregated at a high level. The nature, extent, and timing of the procedures, which are based on the independent accountant's judgment, may vary widely depending on the size and complexity of the institution. The procedures may consist of reviewing changes in account balances from the prior year to the current year using the general ledger or a preliminary or unadjusted working trial balance.

Alternatively, the procedures may involve an extensive analysis of quarterly financial statements, ratios, statistics, and budgeted amounts, including their relationship to the performance of the industry as a whole. In either case, the analytical procedures, combined with the independent accountant's knowledge of the business, serve as a basis for the assessment of the risks of material misstatement.

5.30 Ratios, operating statistics, and other analytical information that may be useful in assessing an institution's position relative to other similar institutions and to industry norms, as well as in identifying unusual relationships between data about the institution itself, are generally readily available. Ratios and statistics developed for use by management or regulators often can be effectively used by the independent accountant in performing analytical procedures for risk assessment purposes. Many institutions disclose analytical information in their annual and quarterly reports. Other sources of information that may be useful for risk assessment purposes are the institution's call reports and the disclosures made by publicly held institutions in accordance with the Securities and Exchange Commission's (SEC's) Industry Guide No. 3, *Statistical Disclosures by Bank Holding Companies*. The *Uniform Bank Performance Reports*, published by the Federal Financial Institutional Examination Council (FFIEC), and the *Annual Bank Operating Statistics*, published by the Federal Deposit Insurance Corporation (FDIC), contain industry data and statistics. There are also several sources of industry data published by private companies. Many of these reports use a peer group format. It is important to understand the relevance of any peer group data to the client institution before making any judgments.

5.31 Analytical procedures involve the comparison of recorded amounts or ratios developed from recorded amounts with expectations developed by the independent accountant. Examples of analytical procedures that may be useful to independent accountants in obtaining an understanding of a bank or savings institution include comparison of account balances with budgeted and prior-period amounts as well as analysis of ratios that indicate relationships among elements of financial information within the period and relationships to similar information about other institutions. For overall review purposes, analytical procedures should focus on considering the adequacy of the evidence gathered in response to unusual or unexpected balances or relationships. The objective of the procedures is to help the independent accountant in assessing the conclusions reached and evaluating the overall financial statement presentation. Analytical procedures also may be used as substantive tests to identify potential misstatements. These procedures focus on comparing actual with expected balances and ratios and investigating and evaluating significant differences.

Discussion Among the Audit Team

5.32 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

Understanding the Entity and Its Environment

5.33 AU section 314 requires auditors to obtain an understanding of the entity and its environment, including its internal control. In accordance with AU section 314.04, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests).

5.34 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies (see paragraph 5.65 below for further discussion)

Refer to Appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to the categories above.

5.35 Paragraph .22 of AU section 329 contains the following documentation guidance for substantive analytical procedures:

> When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:
>
> *a.* The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development
>
> *b.* Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts
>
> *c.* Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

5.36 When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

5.37 A number of the ratios that may be useful to the independent accountant in an audit of the financial statements of an institution are listed below with a brief description of the information they provide:

- *Investments to total assets.* Measures the mix of earning assets
- *Loans to total assets*. Measures the mix of earning assets
- *Investments by type divided by total investments.* Measures the composition of investment portfolio
- *Loans to deposits.* Indicates the funding sources for the loan base
- *Loans by type to total loans.* Measures the composition of loan portfolio and of lending strategy and risk
- *Allowance for loan losses to total loans.* Measures loan portfolio credit risk coverage
- *Loan loss recoveries to prior-year write-offs.* Indicates write-off policy and measure recovery experience
- *Classified loans to total loans.* Indicates asset quality
- *Investment income to average total securities.* Measures investment portfolio yield
- *Allowance for loan losses to classified loans.* Measures management's estimate of losses
- *Loan income to average net loans.* Measures loan portfolio yield
- *Total deposit interest expense to average total deposits.* Measures costs of deposit funds
- *Overhead to total revenue (net interest income plus noninterest income).* Measures operating efficiency
- *Net income to average total assets.* Measures return on assets
- *Net income to average capital.* Measures return on equity
- *Capital ratios.* Measures financial strength and regulatory compliance
- *Noninterest income to total revenue (net interest income plus noninterest income).* Measures the extent of noninterest income
- *Liabilities to shareholders' equity.* Measures the extent equity can cover creditors' claims in the event of liquidation

5.38 For significant risks of material misstatement in an integrated audit, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

Understanding of the Client's Business

5.39 In addition to an understanding of the industry, including matters such as those described in Chapters 1, 2, 3, and 4, the independent accountant should obtain an understanding of matters that are unique to the entity under audit. With regard to financial institutions, such matters include risk management strategies, organizational structure, product lines and services, capital structure, locations, and other operating characteristics. The independent accountant's knowledge of the institution's business should be sufficient to provide an understanding of events, transactions, and practices that may have a significant effect on the institution's financial statements. For public companies, the independent accountant should also obtain an understanding of the operating segments of the business, as defined by the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, paragraph 10.[5]

5.40 An understanding of the entity may also be obtained or supplemented by reading documents such as:

- The charter and bylaws of the institution
- Minutes of meetings of the board of directors, audit committee, credit committee or loan officers or both, and other appropriate committees
- Prior-year and interim financial statements and other relevant reports, such as recently issued registration statements
- Risk management strategies and reports, such as interest rate, asset quality, and liquidity reports
- Organizational charts
- Operating policies, including strategies for lending and in
- Regulatory examination reports
- Correspondence with regulators
- Periodic regulatory financial reports: FFIEC Consolidated Reports of Condition and Income; Office of Thrift Supervision (OTS) Thrift Financial Reports; or National Credit Union Administration (NCUA), collectively, *call reports*
- Sales brochures and other marketing materials
- Capital or business plans
- Internal reports and financial information utilized by management to make segment-related decisions
- The charter and bylaws of the institution

5.41 ***Related Parties***. Obtaining an understanding of a client's business should also include performing the procedures in paragraph .02 of AU section 334, "Accounting Considerations" (AICPA, *Professional Standards*, vol. 1), to determine the existence of related-party relationships and transactions with such parties. FASB Statement No. 57, *Related Party Disclosures*, defines *related parties* as:

a. Affiliates of the institution (a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an institution)

b. Entities for which investments are accounted for by the equity method by the institution

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[5] The FASB issued Emerging Issues Task Force (EITF) Issue No. 04-10, "Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds," to provide additional guidance in determining the aggregating of operating segments.

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts, that are managed by or are under the trusteeship of management of the institution

d. Principal owners of the institution

e. Management of the institution

f. Members of the immediate families of the principal owners of the institution and its management

5.42 Also included in FASB Statement No. 57 definition of related parties are other parties with which the institution may deal if one party controls or can significantly influence the management or operating policies of the other to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party is also a related party if it can significantly influence the management or operating policies of the transacting parties, or if it has an ownership interest in one of the transacting parties and can significantly influence the other to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

5.43 Paragraph .02 of AU section 334 indicates that, in auditing related-party transactions that are identified during the course of the audit, the independent accountant must be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a related-party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.[6] If the institution includes such a representation in the financial statements and the independent accountant believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality. See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1). (For a detailed discussion on reports issued under the guidance of AU section 508 and related PCAOB requirements when performing integrated audits, see Chapter 22 of this Guide.)

Industry Risk Factors

5.44 Independent accountants with clients in the industry should obtain audit evidence about the general business and economic risk factors that affect the industry.[7] There is no list of risk factors that can cover all of the complex characteristics that affect transactions in the industry. However, some of those risk factors are competition for business, innovations in financial instruments, and the role of regulatory policy which are discussed in paragraph 5.34. Emerging regulatory and accounting guidance is discussed throughout this Guide.

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[6] FASB Statement No. 57, Related Party Disclosures, paragraph 3 [AC section R36.103], states that if representations are made about transactions with related parties, the representations "shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated."

[7] An important source of such information is the AICPA's Audit Risk Alert series.

Other primary risk factors (discussion to follow) involve the sensitivity of an institution's earnings to changes in interest rates, liquidity, and asset quality. Independent accountants should consider all such risk factors when planning the audit of an institution's financial statements. Practical considerations of these risk factors for certain transactions are provided in each chapter where appropriate.

Interest-Rate Risk

5.45 In general, financial institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Market interest rates change over time. Accordingly, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest-rate changes.

5.46 For example, assume an institution's assets carry intermediate- or long-term fixed rates. Assume those assets were funded with short-term liabilities. Also assume that interest rates rise by the time the short-term liabilities must be refinanced. The increase in the institution's interest expense on the new liabilities—which carry new, higher rates—will not be offset if assets continue to earn at the long-term fixed rates. Accordingly, the institution's profits would decrease on the transaction because the institution will either have lower net interest income or, possibly, net interest expense. Similar risks exist if assets are subject to contractual interest-rate ceilings, or rate-sensitive assets are funded by longer term, fixed-rate liabilities in a decreasing-rate environment.

5.47 Several techniques might be used by an institution to minimize interest-rate risk. One approach is for the institution to continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates. Such activities fall under the broad definition of asset/liability management.

5.48 One technique used in asset/liability management is measurement of an institution's asset/liability gap—that is, the difference between the cash flow amounts of interest-sensitive assets and liabilities that will be refinanced (or repriced) during a given period. For example, if the asset amount to be repriced exceeds the corresponding liability amount for a certain day, month, year, or longer period, the institution is in an asset-sensitive gap position. In this situation, net interest income would increase if market interest rates rose and decrease if market interest rates fell. If, alternatively, more liabilities than assets will reprice, the institution is in a liability-sensitive position. Accordingly, net interest income would decline when rates rose and increase when rates fell. Such gap analysis assumes that assets and liabilities will be repriced only when they mature—it does not consider opportunities to reprice principal or interest cash flows before maturity. Also, these examples assume that interest-rate changes for assets and liabilities are of the same magnitude, whereas actual interest-rate changes generally differ in magnitude for assets and liabilities.

5.49 Duration analysis is a technique that builds on gap analysis by adding consideration of the average life of a stream of cash flows. The duration of an asset or liability is measured by weighting cash flow amounts based on their timing. Accordingly, duration analysis adds a measure of the effect of the timing of interest-rate changes on earnings.

5.50 Another technique used to analyze interest-rate risk involves simulation models. These models measure the effect of changes in interest rates on the market value of an institution under a premise that interest-rate changes are not static but dynamic. Simulation analysis involves the projection of various interest-rate scenarios over future periods. The estimated cash flows for each rate scenario are discounted to arrive at a present value calculation for each rate scenario. The resulting range of probable risk exposures reflects both current and expected interest-rate risk. The rate scenarios often reflect variations of factors such as the mix of assets and liabilities and related pricing strategies. As with gap and duration analyses, if the assumptions are not valid, the results may not provide an accurate reflection of the institution's interest-rate risk.

5.51 Several ways an institution can affect interest-rate risk include:

- Selling existing assets or repaying certain liabilities
- Matching repricing periods for new assets and liabilities—for example, by shortening terms of new loans or investments
- Hedging existing assets, liabilities, firm commitments, or forecasted transactions

5.52 An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest-rate risk. Interest-rate swaps, futures contracts, options on futures, and other such derivative instruments often are used for this purpose. Because these instruments are sensitive to interest-rate changes, they require management expertise to be effective. Accounting and regulatory guidance for these instruments continue to evolve. Chapter 18, "Futures, Forwards, Options, Swaps, and Similar Financial Instruments," discusses specific accounting and regulatory guidance in this area, as well as related audit considerations.

5.53 Financial institutions are subject to a related risk—prepayment risk—in falling rate environments. For example, mortgage loans and other receivables may be prepaid by a debtor so that the debtor may refund its obligations at new, lower rates. Prepayments of assets carrying the old, higher rates reduce the institution's interest income and overall asset yields. Prepayment risk is discussed further in Chapter 7, "Investments in Debt and Equity Securities."

Liquidity Risk

5.54 A large portion of an institution's liabilities may be short term or due on demand, while most of its assets may be invested in long-term loans or investments. Accordingly, the institution needs to have in place sources of cash to meet short-term demands. These funds can be obtained in cash markets, by borrowing, or by selling assets. Also, the secondary-mortgage, repurchase agreement, and Euro-markets have become increasingly important sources of liquidity for banks and savings institutions. However, if an institution must resort to sales of assets or loans to obtain liquidity, immediate losses will be incurred when the effective rates those assets carry are below market rates at the time of sale. Related audit considerations are addressed in Chapter 7.

5.55 The composition of an institution's deposits also affects liquidity and interest-rate risk because large volumes of deposits can be withdrawn over a short period of time. For example, institutions are also subject to reputation risk. If an institution receives adverse publicity, it may have difficulty retaining deposits and, therefore, become dependent on other forms of borrowing at a higher cost of funds. (Chapter 13, "Deposits," addresses audit considerations for deposits.)

Asset-Quality Risk

5.56 Financial institutions have generally suffered their most severe losses as a result of the loss of expected cash flows due to loan defaults and inadequate collateral. For example, significant credit losses on real estate loans have occurred, due largely to downturns in regional and national real estate markets, but also because of other general economic conditions and higher-risk lending activities. Chapter 9, "Credit Losses," addresses credit losses.

5.57 Other financial assets are subject to other impairment issues—similar to credit quality—that involve subjective determinations. For example, increased prepayments of principal during periods of falling interest rates have a significant impact on the economic value of assets such as mortgage servicing rights.

5.58 Independent accountants who audit financial statements of financial institutions should give particular attention to the assessment of impairment of financial assets. The independent accountant should focus on the methods used, assumptions made, and conclusions reached by management (and outside specialists relied on by management, such as appraisers) in assessing impairment of financial assets. Practical guidance is provided in subsequent chapters.

Fiduciary Risk

5.59 Many financial institutions activities involve custody of financial assets, management of such assets, or both. Fiduciary responsibilities are the focus of activities such as servicing the collateral behind asset-backed securities, managing mutual funds, and administering trusts. These activities expose the institution to the risk of loss arising from failure to properly process transactions or handle the related assets on behalf of third parties. Related audit considerations are addressed in subsequent chapters.

Processing Risk

5.60 Large volumes of transactions must be processed by most financial institutions, generally over short periods of time. Demands placed on both computerized and manual systems can be great. These demands increase the risk that the accuracy and timeliness of related information could be impaired.

5.61 Financial institutions utilize information systems to process large volumes of transactions (for example, arising from banks' electronic funds transfer and check processing operations) on an accurate and timely basis. Related considerations are discussed in subsequent chapters.

Understanding Internal Control

5.62 The assets of financial institutions generally are more negotiable and more liquid than those of other enterprises. As a result, they may be subject to greater risk of loss. In addition, the operations of financial institutions are characterized by a high volume of transactions; as a result, the effectiveness of internal control is a significant audit consideration.[8]

5.63 AU section 314 states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to:

a. Evaluate the design of controls relevant to an audit of financial statements

b. Determine whether they have been implemented

5.64 The auditor should use such knowledge to:

- Identify types of potential misstatements.
- Consider factors that affect the risks of material misstatement.
- Design tests of controls, when applicable, and substantive procedures.

5.65 Obtaining an understanding of the internal controls should be distinguished from testing the operating effectiveness of internal controls. The objective of obtaining an understanding of internal controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risk of material misstatement. In contrast, the objective of testing the operating effectiveness of internal controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

5.66 ***Audits performed in accordance with PCAOB Standards.***[†] Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to the AICPA publication, *PCAOB Standards and Related Rules* for discussion on the extent of test of controls. Specifically, refer to Appendix B, of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing decisions.

5.67 When a company reports material weaknesses in its Internal Control over Financial Reporting, management has the option to seek auditor agreement that the material weakness no longer exists prior to the next annual audit. Auditing Standard No. 4 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") describes the steps to be used by auditors when a

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[8] This section discusses the consideration of internal control in a financial statement audit; it does not address reporting on a written management assertion about financial reporting controls.

[†] In December 2006, the PCAOB proposed Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, and Related Other Proposals*, that would supersede AS2 and all other previous PCAOB guidance related to that standard. See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 2 and related conforming amendments to the PCAOB Standards.

company voluntarily engages them to report on whether a previously disclosed material weakness no longer exists.

5.68 The main objective for auditors performing an engagement in accordance with Auditing Standard No. 4 is to obtain a reasonable assurance as to whether the previously reported material weakness still exists. The work performed by the auditor focuses on whether controls specified by management are operating effectively to properly address the material weakness, as of a specified date by management.

5.69 AU section 314.41 explains that internal control is a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in (*a*) the reliability of financial reporting, (*b*) the effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations.

5.70 AU section 314.41 says that internal control consists of five interrelated components:

a. *Control environment* sets the tone of an institution, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. *Risk assessment* is the institution's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.

c. *Control activities* are the policies and procedures that help ensure management directives are carried out.

d. *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

e. *Monitoring* is a process that assesses the quality of internal control performance over time.

5.71 The five components of internal control are applicable to the audit of every institution and the components should be considered in the context of the following:

- The institution's size
- The institution's organization and ownership characteristics
- The nature of the institution's business
- The diversity and complexity of the institution's operations
- Applicable legal and regulatory requirements
- The nature and complexity of the systems that are part of the institution's internal control, including the use of service organizations.[9]

5.72 AU section 314.48 says that, ordinarily, controls that are relevant to an audit pertain to the institution's objective of preparing financial statements

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[9] See AU section 324.03 and .06–.10, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), for guidance if an institution obtains services that are part of its information system from another organization. For integrated audits refer to paragraphs B18–B29 in Appendix B of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") regarding the use of service organizations.

for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP.

5.73 AU section 314.50 says the controls relating to operations and compliance objectives may be relevant to an audit if they pertain to data the independent accountant evaluates or uses in applying auditing procedures. For example, controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

5.74 ***Information Technology Considerations.*** Financial institutions' operations are characterized by large volumes of transactions and, therefore, generally rely heavily on computers. AU section 314 (AICPA, *Professional Standards*, vol. 1), and AU section 326 provides guidance for independent accountants who have been engaged to audit an entity's financial statements when significant information is transmitted, processed, maintained, or accessed electronically.

5.75 In evaluating an institution's internal control and assessing the risks of material misstatement, control issues involving information technology are significant and should receive considerable attention. The independent accountant should consider matters such as:

- The extent to which information technology is used for significant accounting applications
- The complexity of the institution's information technology, including whether outside service organizations are used
- The organizational structure for information technology, including the extent to which on-line terminals and networks are used
- The physical security controls over computer equipment
- Controls over information technology (for example, program changes and access to data files), operations, and systems
- The availability of data
- The use of information technology assisted audit techniques to increase the efficiency and effectiveness of performing procedures (Using information technology assisted audit techniques may also provide the independent accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the independent accountant to analyze certain data or test specific control procedures without information technology assistance.)

5.76 Some of the accounting data and corroborating audit evidence may be available only in electronic form. For example, entities may use Electronic Data Interchange (EDI) or image processing systems. In image processing systems, documents are scanned and converted into electronic images to facilitate storage and reference, and the source documents may not be retained after conversion. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the independent accountant should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and, if applicable, tests of controls.

5.77 Information technology may be performed solely by the institution, shared with others, or provided by an independent organization supplying specific data-processing services for a fee. AU section 324 provides guidance on the factors that an independent accountant should consider when auditing the financial statements of entities that obtain services that are part of its information system from another organization. When performing an integrated audit, refer to paragraphs B18–B29 in Appendix B of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") regarding the use of service organizations.

5.78 The independent accountant should consider whether specialized skills are needed to consider the effect of information technology on the audit, to understand the internal control, or to design and perform audit procedures. If specialized skills are needed, the independent accountant should seek the assistance of someone possessing such skills who may be either on the independent accountant's staff or an outside professional. If the use of such a professional is planned, the independent accountant should have sufficient information technology related knowledge to communicate the desired objectives to the information technology professional, to evaluate whether the specific procedures will meet the independent accountant's objectives, and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

5.79 System upgrades, conversions, and changes in technology have occurred with increasing frequency in the industry to accommodate the many changes in the nature and complexity of products and services offered, ongoing changes in accounting rules, continually evolving regulations, and mergers and acquisitions. A number of system changes may affect internal control. For example, merging institutions with incompatible computer systems can have a significant negative impact on the surviving institution's internal control. In addition to obtaining the understanding of ongoing or planned changes in processing controls that is necessary to plan the audit, the independent accountant may find it necessary to consider the effect of system changes on:

a. Controls over the accurate conversion of data to new or upgraded systems

b. The effectiveness of data provided to perform analyses, such as those of the institution's performance versus its plan for asset-liability management

c. The adequacy of the institution's disaster recovery plan and system

5.80 The Auditing Standards Board recently issued AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1). AU section 380 establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. Although this section applies regardless of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity. This section does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

5.81 AU section 325, *Communicating Internal Control Related Matters Identified an Audit* (AICPA, *Professional Standards*, vol. 1), requires the auditor to, (1) evaluate control deficiencies identified during the audit and, (2) communicate, in writing, to management and those charged with governance, control deficiencies that are significant deficiencies or material weaknesses in internal control. In evaluating control deficiencies, the auditor should consider the likelihood that a control would not have prevented or detected a misstatement in the financial statements, and the magnitude of the misstatement that could have occurred. The difference between a significant deficiency and a material weakness is the magnitude of the misstatement that could occur. The magnitude of the misstatement for a material weakness is a material misstatement.

5.82 AU section 325 also identifies specified areas in which control deficiencies ordinarily are to be considered as at least a significant deficiency and also identifies specified indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

5.83 An appendix to AU section 325 includes a list of examples of reportable conditions.

5.84 For audits of issuers, in an audit of financial statements only refer to AU section 325.[‡] For an integrated audit of financial statements and internal control over financial reporting conducted in accordance with PCAOB Standards, see paragraphs 207–214 of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards").

Risk Assessment and the Design of Further Audit Procedures

5.85 As discussed in paragraph 5.27, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls and substantive tests. This section provides guidance on assessing the risk of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

5.86 AU section 314.102 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should:

a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.

[‡] The PCAOB has recently issued Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards").

b. Relate the identified risks to what can go wrong at the relevant assertion level.

c. Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.

d. Consider the likelihood that the risks could result in a material misstatement of the financial statements.

5.87 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risk of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

5.88 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as "significant risks"). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318 *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

5.89 AU section 318 provides guidance about implementing the third standard of field work, as follows: "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

5.90 To reduce audit risk to an acceptably low level, the auditor (1) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (2) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the financial statement and relevant assertion levels. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risk of material misstatement.

Overall Responses

5.91 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

5.92 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risk of material misstatement at the relevant assertion level.

5.93 In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

5.94 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. When, in accordance AU section 314.117, the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion.

5.95 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

5.96 Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

5.97 Substantive procedures are performed to detect material misstatements at the relevant assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The auditor should plan and perform substantive procedures to be responsive to the related assessment of the risk of material misstatement.

5.98 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

5.99 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

Evaluating Misstatements

5.100 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. AU section 312.42 states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management. AU section 312 further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.[||]

5.101 For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 and AU section 326 respectively.

Audit Documentation—Audits Conducted in Accordance With GAAS

5.102 AU section 150 states in the third standard of field work that an auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

[||] The SEC recently issued Staff Accounting Bulletin (SAB) No. 108 which amends the table in Subpart B of Part 211 of Title 17 of the Code of Federal Regulations. The SAB points out that some registrants do not consider the effects of prior year errors on current year financial statements. This allows the entity to report unadjusted (and improper) assets and liabilities. The SAB also notes that an immaterial error on the balance sheet could be material on the income statement. The purpose to the SAB is to address diversity in practice in quantifying financial statement misstatements and the potential build up of improper accounts on the balance sheet. The Staff Accounting Bulletin is effective for any report with a fiscal year ending after November 15, 2006. In response to SAB No. 108, the FASB has proposed FSP 154-a, *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements*, in September 2006. This FASB FSP extends the guidance for SEC registrants in SAB 108 to all other nongovernmental entities that are not subject to the requirements of SAB 108, conforming the reporting of error corrections between SEC registrants and other entities. In effect, FSP 154-a in conjunction with SAB 108 establishes a single approach for quantifying misstatements that could be material to users of financial statements. Proposed FSP 154-a is out for comment until April 30, 2007.

5.103 AU section 326 defines audit evidence as all the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

5.104 AU section 326 also replaces the term sufficient, competent evidence with sufficient, appropriate audit evidence.

5.105 AU section 339.01, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides that the auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment.

5.106 AU section 339.02 states that audit documentation serves mainly to:

a. Provide the principal support for the auditor's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference in the report to GAAS.[10]

b. Aid the auditor in the conduct and supervision of the audit.

5.107 AU section 339.03 states that examples of audit documentation are audit programs analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents, and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form, or other media.

5.108 AU section 339.04 states that audit documentation should be sufficient to (*a*) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained;[11] (*b*) indicate the engagement team member(s) who performed and reviewed the work; and (*c*) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

5.109 In addition to the requirements discussed above, AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides further requirements about the content, ownership, and confidentiality of audit documentation. Moreover, Appendix A to AU section 339 lists the audit documentation requirements contained in other areas of the AICPA, *Professional Standards*.

5.110 AU section 339 superseded SAS No. 96, of the same name, and amended, AU section 530. The Statement is effective for audits of financial statements for periods ending on or after December 15, 2006.

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[10] However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

[11] A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including GAAS, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. Also, see AU section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (AICPA, *Professional Standards*, vol. 1).

5.111 The auditor **must** prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusion reached. Audit documentation:

a. Provide the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally acceptable auditing standards.

b. Provides that principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

5.112 Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

5.113 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or workpapers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.

5.114 Audit documentation includes, for example audit programs, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.

Audit Documentation—Audits Conducted in Accordance With PCAOB Standards

5.115 AU section 339, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*), established general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to PCAOB Standards. Audit documentation is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. This Standard provides specific audit document requirements, provides guidance on documentation of specific matters, and retention of and subsequent changes to audit documentation. See PCAOB Auditing Standard No. 3 for further guidance.

5.116 FASB Technical Bulletin (TB) No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement No. 140 Related to* *the Isolation of Transferred Financial Assets*, deferred the application of the isolation standards of FASB Statement No. 140, as clarified in the FASB staff guidance published in April, 2001, to banks and certain other financial institutions. Those institutions were also allowed up to five years of additional transition time for transfers of assets to certain securitization master trusts. The additional transition time applied only if all beneficial interests issued to investors after July 23, 2001, permitted the changes in structure necessary to comply with those isolation standards. The transition period to apply FASB Statement No. 140 ended June 30, 2006.

Processing of Transactions by Service Organizations

5.117 For audits of issuers, AU section 324.06–.21[12] provides guidance on the user auditor's consideration of the effect of a service organization on internal control of the user organization and availability of audit evidence. That guidance should be considered when planning and performing the audit of the financial statements of an institution that uses a service organization to process transactions (for example, using a mortgage banker to service mortgages). In performing an integrated audit, refer to paragraphs B18–B29 in Appendix B of Auditing Standard No. 2, (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards").

Consideration of Fraud in a Financial Statement Audit[#]

5.118 AU section 316 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in AU section 110.02, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1). When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB Standards, auditors are required to refer to paragraphs 24–26 of Auditing Standard

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[12] The ASB issued an Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*. The Guide includes illustrative control objectives as well as Interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers. Readers should be aware of the guidance in the Guide.

[#] The SEC recently issued Staff Accounting Bulletin (SAB) No. 108 which amends the table in Subpart B of Part 211 of Title 17 of the Code of Federal Regulations. The SAB points out that some registrants do not consider the effects of prior year errors on current year financial statements. This allows the entity to report unadjusted (and improper) assets and liabilities. The SAB also notes that an immaterial error on the balance sheet could be material on the income statement. The purpose to the SAB is to address diversity in practice in quantifying financial statement misstatements and the potential build up of improper accounts on the balance sheet. The Staff Accounting Bulletin is effective for any report with a fiscal year ending after November 15, 2006. In response to SAB No. 108, the FASB has proposed FSP 154-a, *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements*, in September 2006. This FASB FSP extends the guidance for SEC registrants in SAB 108 to all other nongovernmental entities that are not subject to the requirements of SAB 108, conforming the reporting of error corrections between SEC registrants and other entities. In effect, proposed FSP 154-a in conjunction with SAB 108 establishes a single approach for quantifying misstatements that could be material to users of financial statements. Proposed FSP 154-a is out for comment until April 30, 2007.

No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316 (AICPA, *PCAOB Standards and Related Rules*). [‡]

5.119 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

5.120 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

5.121 ***The Importance of Exercising Professional Skepticism.*** Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mind-set that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

5.122 ***Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud.***[13] Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of AU section 316.14–.18 (AICPA, *Professional Standards*, vol. 1). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives or pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Exhibit 5-1, "Fraud Risk Factors," which appears at the end of this chapter, contains a list of fraud risk factors that auditors may consider as part of their planning and audit procedures. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

5.123 ***Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud.*** AU section 314 (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates to assess the risks of material misstatement. In performing

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[‡] See footnote ‡ in paragraph 5.84.

[13] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1) to discuss the potential of the risk of material misstatement.

that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in AU section 316.35–.42 (AICPA, *Professional Standards*, vol. 1) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See AU section 316.20–.27, AICPA, *Professional Standards*, vol. 1.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See AU section 316.28–.30, AICPA, *Professional Standards*, vol. 1.)

c. Consider whether one or more fraud risk factors exist. See the Appendix to AU section 316.85 (AICPA, *Professional Standards*, vol. 1) and Exhibit 5-1 at the end of this chapter.

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See AU section 316.34, AICPA, *Professional Standards*, vol. 1.)

5.124 In obtaining an understanding of the entity, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

5.125 ***Considering Fraud Risk Factors.*** As indicated in item c above, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

5.126 AU section 316 provides fraud risk factor examples that have been written to apply to most enterprises. Exhibit 5-1 at the end of this chapter contains a list of fraud risk factors specific to financial institutions. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

5.127 ***Identifying Risks That May Result in a Material Misstatement Due to Fraud.*** In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of AU section 316.19–.34 (AICPA, *Professional Standards*, vol. 1). The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

5.128 ***A Presumption That Improper Revenue Recognition Is a Fraud Risk.*** Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See AU section 316.41, AICPA, *Professional Standards*, vol. 1).

5.129 ***A Consideration of the Risk of Management Override of Controls.*** Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (AU section 316.57, AICPA, *Professional Standards*, vol. 1) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in AU section 316.58–.67 (AICPA, *Professional Standards*, vol. 1) should be performed to further address the risk of management override of controls. These procedures include (*a*) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (*b*) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (*c*) evaluating the business rationale for significant unusual transactions.

5.130 ***Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks.*** Auditors should comply with the requirements of AU section 316.43–.45 (AICPA, *Professional Standards*, vol. 1) concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

5.131 ***Responding to the Results of the Assessment.*** AU section 316.46–.67 (AICPA, *Professional Standards*, vol. 1) provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned. (See AU section 316.50, AICPA, *Professional Standards*, vol. 1.)

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed. (See AU section 316.51–.56, AICPA, *Professional Standards*, vol. 1.)

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur. (See AU section 316.57–.67, AICPA, *Professional Standards*, vol. 1.)

5.132 ***Evaluating Audit Evidence.*** AU section 316.68–.78 (AICPA, *Professional Standards*, vol. 1) provides requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

5.133 AU section 318 states the auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements. In developing an opinion, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions in the financial statements.

5.134 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

5.135 ***Responding to Misstatements That May Be the Result of Fraud.*** When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See AU section 316.75–.78 (AICPA, *Professional Standards*, vol. 1) for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

5.136 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.[14]

b. Consider the implications for other aspects of the audit. (See AU section 316.76, AICPA, *Professional Standards*, vol. 1.)

c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level

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[14] See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), for guidance on auditors' reports issued in connection with audits of financial statements.

above those involved, and with senior management and the audit committee.[15]

5.137 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

5.138 ***Communicating About Possible Fraud to Management, the Audit Committee, and Others.*** Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See AU section 316.79–.82 (AICPA, *Professional Standards*, vol. 1) for further requirements and guidance about communications with management, the audit committee, and others.

5.139 ***Documenting the Auditor's Consideration of Fraud.*** AU section 316.83 (AICPA, *Professional Standards*, vol. 1) requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

5.140 ***Practical Guidance.*** The AICPA Practice Aid, *Fraud Detection in a GAAS Audit—Revised Edition*, provides a wealth of information and help on complying with the provisions of AU section 316. This Practice Aid is an Other Auditing Publication as defined in AU section 150, *Generally Accepted Auditing Standards*, by AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1). In December 2005 AU section 120 was issued and effective upon issuance.[**] Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply other sections of the AICPA Professional Standards.

5.141 ***Internal Audit Considerations.*** AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides guidance on the independent accountant's consideration of the existence of an internal audit function in determining the nature, timing, and extent of auditing procedures to be performed, and on using internal auditors to provide direct assistance to the independent accountant in an audit of financial statements performed in accordance with GAAS. When performing an integrated audit, refer to paragraphs 108–126 of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for a discussion on using the work of others to alter the nature, timing and extent of the work that otherwise would have been performed to test controls. When performing an integrated audit, refer to paragraphs 98–103 of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") regarding the timing of test of controls.

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[15] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

[**] See footnote * in the title of this chapter for additional information regarding SAS No. 102.

Compliance With Laws and Regulations

5.142 AU section 311.07 (AICPA, *Professional Standards*, vol. 1) states that, in planning the audit, the independent accountant should consider "matters affecting the industry in which the entity operates, such as economic conditions, government regulations, and changes in technology, as they relate to his audit [*emphasis added*]." In performing an audit of financial statements, the independent accountant considers government regulations in light of how they might affect the financial statement assertions.

5.143 AU section 317 prescribes the nature and extent of the independent accountant's consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with GAAS.

5.144 The term *illegal* acts refers to violations of laws or governmental regulations. Illegal acts vary considerably in their relation to the financial statements. The independent accountant's responsibility to detect and report misstatements resulting from illegal acts is dependent on the relationship between the law or regulation that is violated and the financial statements.

5.145 Some laws and regulations have a direct and possibly material effect on the determination of financial statement amounts. For example:

- Tax laws affect accruals and the amount recognized as expense in the accounting period.
- Certain laws and regulations place limits on the nature or amount of investments that institutions are permitted to hold. Such laws and regulations may affect the classification and valuation of assets.

5.146 Other laws and regulations relate more to an institution's operating aspects than to its financial and accounting aspects, and their effect on the financial statements is indirect. Examples of such laws and regulations include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, money laundering, and antitrust violations. Another example of such laws and regulations are those that require institutions to report certain financial transactions to governmental agencies. The indirect effect of violations of such laws and regulations is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

5.147 The ultimate responsibility for compliance with laws and regulations rests with management of the institution. Nonetheless, throughout the audit, the independent accountant should be aware of the possibility that illegal acts that could have a material effect on the institution's financial statements may have occurred. The independent accountant should design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. If specific information comes to the independent accountant's attention that provides evidence of other possible illegal acts that could have a material indirect effect on the financial statements, the independent accountant should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit conducted in accordance with GAAS provides no assurance that indirect-effect illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Going-Concern Considerations

5.148 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), requires independent accountants to evaluate—as part of every financial statement audit—whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The independent accountant's evaluation of an institution's ability to continue as a going concern may be one of the most complex and important portions of the audit. This section describes the unique issues that an independent accountant may encounter in evaluating an institution's ability to continue as a going concern.

5.149 Financial institutions operate in a highly regulated environment. As a result, laws and regulations can have a significant effect on their operations. The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the FDIC Improvement Act of 1991 dramatically changed the regulatory environment in the banking and thrift industries and imposed new regulatory capital requirements that are far more stringent than previous requirements. Chapter 1 includes a discussion of regulatory capital requirements for banks and savings institutions and such requirements for credit unions are discussed in Chapter 2.

5.150 In accordance with AU section 341, the independent accountant should consider whether there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time in the following manner:

a. The independent accountant considers whether the results of procedures performed in planning, gathering audit evidence relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. If the above considerations lead the independent accountant to believe that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, the independent accountant should obtain information about management's plans intended to mitigate the adverse effects of the conditions or events that gave rise to the doubt and assess the likelihood that such plans can be effectively implemented.

c. After evaluating management's plans, the independent accountant concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

5.151 AU section 341 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures normally performed in audits of the financial statements of banks and savings institutions that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of the board of directors and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support
- Review of the financial strength and liquidity of the parent company, if applicable
- Review of reports of significant examinations and related communications between examiners and the institution
- Review of compliance with regulatory capital requirements

5.152 In performing such audit procedures, the independent accountant may identify information about certain conditions or events that, when considered in the aggregate, indicate that there could be substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of financial institutions:

- Recurring operating losses
- Indications of strained liquidity
- Failure to meet minimum regulatory capital requirements or to adhere to the terms of an approved capital plan
- Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe or unsound practices
- Indications of strained relationships between management and regulatory authorities

5.153 AU section 341 states that if, after considering management's plans, the independent accountant concludes that there is substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time, the independent accountant should consider the possible effects on the financial statements and the adequacy of the related disclosures. Some of the information that might be disclosed includes:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time
- The possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible regulatory sanctions, including the discontinuance of operations

- Management's plans (including information about the institution's capital plan and relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

5.154 If, upon consideration of management's plans, the independent accountant concludes that substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time is alleviated, the independent accountant should consider the need for disclosure in the financial statements of the principal conditions and events that initially caused the independent accountant to believe there was substantial doubt. Disclosure should include the possible effects of such conditions and events and any mitigating factors, including management's plans.

5.155 If the independent accountant concludes that substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion. The independent accountant's decision about whether modification of the standard report is appropriate may depend also on:

- The institution's existing regulatory-capital position
- The likelihood that the institution's regulatory-capital position will improve or deteriorate within the next twelve months
- Whether the plan has been accepted by regulatory authorities
- The independent accountant's assessment of the institution's ability to achieve its capital plan, if any

5.156 Paragraph 22.13 of this Guide discusses circumstances in which the independent accountant might disclaim an opinion.

5.157 The decision about the appropriate form of audit report to issue in particular circumstances is often a complex judgment that requires considerable professional experience. The independent accountant may have to communicate with the regulator to assist with the auditor's assessment. (Refer to Chapter 1 for a discussion of required communications with regulators.) Chapter 22 includes an illustration of a report that includes such an explanatory paragraph.

5.158 AU section 341 states that in connection with the guidance stated above, the auditor should document all of the following:

- The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events
- The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans
- The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or has been alleviated (If substantial doubt remains, the auditor also should document the possible effects of

the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.)

- The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report (If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusions as to whether to express a qualified or adverse opinion for the resultant departure from GAAP.)

Client Representations

5.159 AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), requires that the independent accountant obtain written representations from management as part of an audit financial statements performed in accordance with GAAS or PCAOB Standards and provides guidance concerning the representations to be obtained. Such representations are part of the audit evidence the independent accountant obtains but are not a substitute for the application of auditing procedures. The accountant obtains written representations from management to complement other auditing procedures. Written representations from management should be obtained for all financial statements and periods covered by the accountant's report. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. AU section 333.06 (AICPA, *Professional Standards*, vol. 1) lists matters ordinarily included in management's representation letter. When performing an integrated audit, refer to paragraphs 142–144 of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for additional required written representations to be obtained from management. Additional representations specific to banks and savings institutions and/or credit unions that may be obtained include the following:

- All regulatory examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies (particularly communications concerning supervisory actions or noncompliance with or deficiencies in the rules and regulations or supervisory actions) have been provided to the independent accountant.
- The classification of securities between held-to-maturity, available-for-sale, or trading categories accurately reflects management's ability and intent.
- The methodology for determining fair value disclosures is based on reasonable assumptions.
- Adequate disclosure has been made of the status of the institution's capital plan filed with regulators, if applicable, and management believes it is in compliance with any formal agreements or orders in any memorandum of understanding or cease-and-desist order.
- Contingent assets and liabilities have been adequately disclosed in the financial statements.

- Related-party transactions have been entered into in compliance with existing regulations.
- Adequate provision has been made for any losses, costs, or expenses that may be incurred on securities, loans, or leases and real estate as of the balance-sheet date.
- Other than temporary declines in the value of investment securities have been properly recognized in the financial statements.
- Commitments to purchase or sell securities under forward-placement, financial-futures contracts, and standby commitments have been adequately disclosed in the financial statements.
- Sales with recourse have been adequately disclosed in the financial statements.
- Proper disclosure has been made regarding the nature, terms, and credit risk of financial instruments with off-balance-sheet risk.
- No transactions or activities are planned that would result in any recapture of the base-year, tax-basis bad debt reserves.
- Proper disclosure has been made regarding financial instruments with significant:
  - — Off-balance-sheet risk
  - — Individual or group concentrations of credit risk

5.160 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the accountant have reached an understanding on materiality for this purpose. The representations should be made as of a date no earlier than the date of the accountant's report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an accountant to disclaim an opinion or withdraw from the engagement.

5.161 AU Section 333, *Management Representations*, written representations must be addressed to the auditor. Because the auditor is concerned with events that occurred through the date of his or her report that may require adjustment or disclosure, the representations should be made as of the date of the auditor's report. This was changed from "as a date no earlier than." The management rep letter should be signed by members of management with overall responsibility for financial and operating matters. Normally this includes the chief executive officer, and the chief financial officer, among others. This amendment to AU section 333 is effective for audits of financial statements for periods ending on or after December 15, 2006.

5.162 As amended by SAS No. 113, *Omnibus-2006*, SAS No. 1 *Codification of Auditing Standards and Procedures* ("Subsequent Events"), the auditor is required to obtain the letter of representation, dated as of the date of the auditor's report, from appropriate officials, usually the chief executive officer, chief financial officer, or equivalent.

Information Other Than Financial Statements

5.163 An institution may publish various documents that contain information in addition to audited financial statements and the independent auditor's report thereon. AU section 550, *Other Information in Documents Containing*

Audited Financial Statements (AICPA, *Professional Standards*, vol. 1), provides guidance for the independent accountants and clarifies that an auditor may issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on supplementary information and other information that has been subjected to the auditing procedures applied in the audit of those basic financial statements.

5.164 In some circumstances, an independent accountant submits to the client or others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), provides guidance to clarify reporting with respect to required supplementary information as to whether the auditor is permitted to report that required supplementary information in an auditor-submitted document is neither incomplete nor otherwise deficient and is fairly stated in relation to the basic financial statements taken as a whole.

5.165 AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1), also provides guidance on the nature of procedures to be applied to supplementary information required by GAAP and describes the circumstances that would require the auditor to report such information.

Certain Financial Reporting Matters

Disclosures of Certain Significant Risks and Uncertainties

5.166 AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*,[16] requires institutions to include in their financial statements disclosures about (*a*) the nature of their operations and (*b*) the use of estimates in the preparation of their financial statements. Following are illustrations of application of these disclosure requirements by a bank or savings institution.

> *Nature of Operations.* ABC Institution operates seven branches in rural and suburban communities in the United States Midwest. The Institution's primary source of revenue is providing loans to customers, that are predominantly small and middle-market businesses and middle-income individuals.
>
> *Use of Estimates in the Preparation of Financial Statements.* The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and that affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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[16] The FASB issued FASB Staff Position (FSP) FAS SOP 94-6-1, *Term Loans Products That May Give Rise to a Concentration of Credit Risk*. The guidance in this FSP is effective for interim and annual periods ending after December 19, 2005. An entity shall provide the disclosures required by FASB Statement No. 107 for products that are determined to represent a concentration of credit risk in accordance with the guidance in Question 1 for all periods presented.

5.167 If specified disclosure criteria are met, SOP 94-6[17] also requires institutions to include in their financial statements disclosures about (*a*) certain significant estimates and (*b*) current vulnerability due to certain concentrations. Following are a discussion and illustrations of application of SOP 94-6 by a bank or savings institution to example events and circumstances that meet the disclosure criteria.

Certain Significant Estimates

5.168 Paragraphs 12 and 13 of SOP 94–6 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies when information available prior to issuance of the financial statements indicates that both of the following criteria are met:

a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

5.169 Paragraph 14 of SOP 94-6 says the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. Paragraph 14 further requires that, if the estimate involves a loss contingency covered by FASB Statement No. 5, *Accounting for Contingencies*, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.[18]

5.170 Following is an illustrative disclosure about the allowance for loan losses when no uncertainties meet the disclosure criteria established in SOP 94-6, paragraph 13 and FASB Statement No. 5, paragraph 10.

> *Allowance for Loan Losses.* The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.
>
> The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently

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[17] See footnote 16 in paragraph 5.166.

[18] Paragraph 10 of FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows: If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or *if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred*. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

5.171 The following illustrates a paragraph that might be added to the illustration in paragraph 5.168 to disclose an uncertainty that meets the disclosure criteria of paragraph 13 in SOP 94-6, is a loss contingency covered by FASB Statement No. 5, and affects the estimate of loan losses for only some portion of the institution's loan portfolio:

> Three of the Institution's seven branches are in communities that were flooded in late 200X. These branches made loans to individuals and businesses affected by the flooding and the Institution considered the flood's effect in determining the adequacy of the allowance for loan losses. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to that event.[19]

5.172 The following illustrates a paragraph that might be added to the illustration in paragraph 5.168 to disclose an uncertainty that meets the disclosure criteria of paragraph 13 in SOP 94-6 and is a loss contingency covered by FASB Statement No. 5:

> The Institution lends primarily to individuals employed at ABC Air Force Base and businesses local to the base. On December 19, 20X3, the President of the United States ratified a plan that includes the closing of the base effective November 20X4. It is reasonably possible that a change in estimated loan losses will occur in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to the base closing.

5.173 Paragraph 18 of SOP 94-6 gives examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for loans, examples of similar estimates often included in banks' savings institutions' and credit unions' financial statements include:

- Impairment of long-lived assets, for example, assets related to marginal branches
- Estimates involving assumed prepayments, for example, discounts or premiums on certain financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related securities
- Lives of goodwill and identifiable intangible assets (for example, depositor or borrower relationships)

5.174 For example, during 20X5, DEF Bank evaluated the profitability of its branch operations. DEF Bank determined that it will significantly change the extent or manner in which it uses a group of long-lived assets related to six of its branches. In applying FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, DEF Bank determined that the

[19] If a range of possible loss can be estimated, the last sentence might say: It is reasonably possible that in the near term loan losses with respect to that event could be $5 million to $7 million more than estimated in the allowance for loan losses. If the possible loss can be estimated, the last sentence might say: It is reasonably possible that in the near term loan losses with respect to that event could be $6 million more than estimated in the allowance for loan losses.

sum of the estimated future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset group, excluding interest charges, exceeds the carrying amount of the long-lived asset group. In addition, the carrying amount of the asset group does not exceed its fair value. Thus, an impairment loss has not been recognized under FASB Statement No. 144. The significant change in the extent or manner in which the assets are used, however, indicates that the estimate associated with the carrying amounts of those assets may be particularly sensitive in the near term.[20] Following is an illustrative disclosure.

> Management of DEF Bank has reevaluated and will significantly change its use of a group of long-lived assets associated with six of its branches. It is reasonably possible that the Bank's estimate of the carrying amounts of these assets will change in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible.

Current Vulnerability Due to Certain Concentrations

5.175 Paragraph 21 of SOP 94-6 requires institutions to disclose the concentrations described in paragraph 22 of the Statement if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the institution vulnerable to the risk of a near-term severe impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

5.176 SOP 94-6 does not address concentrations of financial instruments. However, as discussed in Chapters 7, "Investments in Debt and Equity Securities;" 8, "Loans;" 18, "Futures, Forwards, Options, Swaps, and Similar Financial Instruments" and elsewhere in this Guide, FASB Statement No. 107, *Disclosures of Fair Values of Financial Instruments*, as amended, includes the disclosure provisions about concentrations of credit risk.[21]

5.177 The following concentrations described in SOP 94-6, paragraph 22 require disclosure if they meet the criteria of paragraph 21 of the Statement:

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor

b. Concentrations in revenue from particular products, services, or fund-raising events

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[20] Paragraph 8 of FASB Statement No. 144 requires that a long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition is an example of an event or change in circumstances that (*a*) paragraph 8b of FASB Statement No. 144 says indicates that the recoverability of the carrying amount of a long-lived asset (asset group) should be tested and (*b*) paragraph 19b of SOP 94-6 says indicates that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term.

[21] See footnote 17 in paragraph 5.167.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations

d. Concentrations in the market or geographic area in which an entity conducts its operations

5.178 Examples of concentrations that may fall in one or more of these categories and that may exist at certain financial institutions include:

- Sale of a substantial portion of or all receivables or loan products to a single customer
- Loss of approved status as a seller to or servicer for a third party
- Concentration of revenue from issuances involving a third-party guarantee program
- Concentration of revenue from mortgage banking activities
- In the case of a credit union, membership in the institution is concentrated with employees of a specific industry or in a region.

5.179 For example, assume a significant portion of GHI Institution's net income is from sales of originated loans. In 20X5, GHI Institution originated $800 million of loans. GHI Institution sold the loans and servicing rights to a substantial portion of these loans to a single servicer, TCB. TCB has historically purchased a substantial portion of the loans and servicing originated by GHI Institution. Following is an illustrative disclosure:

> A substantial portion of GHI Institution's loan and loan-servicing-right originations is sold to a single servicer.

5.180 Assume a significant portion of JKL Bank's revenues is from the origination of loans guaranteed by the Small Business Administration (SBA) under its Section 7 program and sale of the guaranteed portions of those loans. Funding for the Section 7 program depends on annual appropriations by the U.S. Congress. The customer base for this lending specialization and the resulting profits depend on the continuation of the program. Following is an illustrative disclosure:

> A substantial portion of JKL Bank's revenues is from origination of loans guaranteed by the Small Business Administration under its Section 7 program and sale of the guaranteed portions of those loans. Funding for the Section 7 program depends on annual appropriations by the U.S. Congress.

Segment Reporting

5.181 FASB Statement No. 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. The independent accountant should refer to FASB Statement No. 131 for more discussion and detail regarding the Statement's requirements. Auditing Interpretation No. 4 in AU section 9326.28–.41, "Applying Auditing Procedures to Segment Disclosures in Financial Statements" (AICPA, *Professional Standards*, vol. 1), provides guidance for auditing segment disclosures.

Regulation and Supervision of Depository Institutions

Introduction

5.182 Laws and their implementing regulations affect the areas and ways in which certain financial institutions operate while creating standards with which those institutions must comply. Some laws and regulations directly address the responsibilities of independent accountants.[22]

5.183 The primary objective of this section is to explain why and how independent accountants should consider regulatory matters in the audits of certain financial institutions. This chapter also addresses the overall regulatory approach and environment, and the relative responsibilities of those institutions, examiners, and independent accountants. Considerations independent accountants should give to specific areas of regulation are highlighted in subsequent chapters.

5.184 Independent accountants should be familiar with regulations because of the impact regulations have on independent accountants:

a. Acceptance of engagements in the affected industry

b. Planning activities (that is, development of the expected conduct and scope of an engagement)

c. Responsibility for detection of errors and irregularities

d. Evaluation of contingent liabilities and related disclosures

e. Consideration of an institution's ability to continue as a going concern

5.185 As required by AU section 311, independent accountants should consider matters affecting the industry in which the entity operates, such as government regulations. In that regard, it is helpful for independent accountants to be familiar with the nature and purpose of regulatory examinations—including the differences and relationship between examinations and financial statement audits.

5.186 Finally, an understanding of the regulatory environment in which these institutions operate is necessary to complement the independent accountant's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the independent accountant must monitor relevant regulatory changes and consider their implications in the audit process.

5.187 One primary objective of regulation is to maintain the strength of the financial system, in turn, promoting and enforcing the public role of certain financial institutions as financial intermediaries, protecting depositors, and preserving funds for federal deposit insurance. Regulations are generally associated with one or more of the following objectives: capital adequacy, asset quality, management competence, earnings, liquidity, and sensitivity to market risk.

5.188 Many laws and areas of regulation address the public role of certain financial institutions. For example, laws and regulations exist to ensure

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[22] Although the discussion in this chapter is focused on federal regulation, it also may be useful in considering state regulatory matters, especially the impact of regulatory matters on the independent accountant. Further, the Guide does not address specific state regulations that may be relevant in the audit of financial statements.

the availability of credit to all creditworthy applicants without discrimination and to satisfy the credit needs of low- and moderate-income neighborhoods in institutions' local communities.

5.189 Other regulations address directly these institution's operations and, therefore, have broader financial implications. For example, rules exist that restrict the acceptance and renewal of brokered deposits based on a bank or savings institution's level of capitalization.

5.190 In addition to the specific regulatory matters outlined in subsequent chapters, the three aspects of the regulatory process that are particularly important to independent accountants are rule making, examinations, and enforcement.

Rule Making

5.191 Regulations are created by the agencies based on their ongoing authority or as specifically mandated by legislation. Proposed rules and regulations are generally published for comment in the *Federal Register*, a daily publication of the federal government. Final rules also appear in the *Federal Register* and are codified in Title 12 of the Code of Federal Regulations (12 CFR). The *Federal Register* may be accessed at the Government Printing Office (GPO) Web site. The rules applicable to a given institution depend on the institution's charter and other factors, such as whether it is federally insured and whether it is a member of the Federal Reserve System. Institutions are informed of new rules, policies, and guidance through publications of the agencies.

5.192 Discussions of specific regulatory matters found throughout this Guide should not be substituted for a complete reading of related regulations, rulings, or other documents where appropriate. Also, independent accountants should keep apprised of recent changes in regulations, as the regulatory environment is constantly changing.

Examinations

5.193 As used in this guide, the term *audit* refers to an audit performed by an independent accountant for the purpose of expressing an opinion on an institution's financial statements, unless the context in which the term is used clearly indicates that the reference is to an internal audit. The term *examination* generally refers to an examination made by a regulatory authority. There are several types of regulatory examinations, including a Safety and Soundness Examination, an Information Systems Examination, a Trust Examination and a Compliance Examination. These examinations may be combined or performed separately. The purpose of the regulatory examination is to determine the safety and soundness of an institution. The term *examiner* as used in this Guide means those individuals—acting on behalf of a regulatory agency—responsible for supervising the performance and/or preparation of reports of examination and, when appropriate, supervisory personnel at the district and national level.

5.194 Federally insured financial institutions are required to have periodic full-scope, on-site examinations by the appropriate agency. In some cases the OCC and the Federal Reserve will perform off site examinations. In certain cases, an examination by a state regulatory agency is accepted. Full-scope and other examinations are intended primarily to provide early identification of problems at insured institutions rather than as a basis for expressing an opinion on fair presentation of an institution's financial statements.

5.195 The scope of an examination is generally unique to each institution based on risk factors assessed by the examiner; however, general areas that might be covered include:

- Capital adequacy
- Asset quality
- Management
- Earnings
- Liquidity
- Sensitivity to market risk
- Funds management
- Internal systems and controls
- Consumer affairs
- Electronic data processing
- Fiduciary activities

5.196 Examinations are sometimes targeted to a specific area of operations. Separate compliance examination programs also exist to address institutions' compliance with laws and regulations in areas such as consumer protection, insider transactions, and reporting under the Bank Secrecy and USA Patriot Acts.

5.197 An examination generally begins with a review of various background material and information, including practices, policies and/or procedures established by an institution. The examiner compares these practices, policies, and/or procedures to regulatory and supervisory requirements and assesses the institution's adherence to sound fundamental principles in its day-to-day operations. Any additional detailed procedures considered necessary are then applied. A written report of procedures and findings is then prepared by the examiner. The relationship between the work of the examiner and that of the independent accountant is further discussed below.

5.198 Results of examinations are also used in assigning the institution a rating under regulatory rating systems. The FFIEC has adopted the Uniform Financial Institutions Rating System, which bases an institution's composite CAMELS (the rating on component factors addressing capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk). Further, the Board of Governors of the Federal Reserve System (FRB) assigns BOPEC (the rating stands for the five key areas of supervisory concern: the condition of the BHC's bank subsidiaries, other nonbank subsidiaries, parent company, earnings, and capital adequacy) ratings to bank holding companies based on consideration of the bank's CAMELS rating, operation of significant nonbanking subsidiaries, the parent's strength and operations, earnings of the banking organization, and capital of the banking organization). Both systems involve a 5-point rating scale, 1 being the highest possible rating.

Enforcement

5.199 Regulatory enforcement is sometimes carried out through a written agreement between the regulator and the institution—ranging from the least severe commitment letter to a cease-and-desist order. Among other actions that can be taken, the agencies may enforce regulations by:

- Ordering an institution to cease and desist from certain practices or violations
- Removing an officer or prohibiting an officer from participating in the affairs of the institution or the industry
- Assessing civil money penalties
- Terminating insurance of an institution's deposits

5.200 The examination focus has shifted from complete reliance on transaction testing to an assessment of risks and each of the agencies has issued guidance on "supervision by risk," under which examiners identify the risks a bank faces and evaluate how the institution manages those risks. Derivative activities (including the use of credit derivatives), as well as the trading activities of banks have also received increased scrutiny. In addition, recent losses involving fraud have led to a reemphasis on the identification of significant internal control weaknesses and other potential indicators of fraud.

5.201 Further, insured financial institutions may be subject to other mandatory and discretionary actions taken by regulators under prompt corrective action provisions of the FDI Act and the Federal Credit Union Act (FCUA). As described in Chapters 1 and 2, possible actions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

5.202 Many enforcement actions—such as civil money penalties—apply not only to an insured financial institution but also to a broader class of institution-affiliated parties, which could include independent accountants. For example, regulatory agencies may assess civil money penalties of up to $1.1 million per day against an institution or institution-affiliated party that violates a written agreement or any condition imposed in writing by the agency, breaches a fiduciary duty, or engages in *unsafe* or *unsound* practices. Because the term *unsafe* or *unsound* is not defined in any law or regulation, the potential liability of institution-affiliated parties is great.

5.203 The FDI Act also authorizes the agencies that regulate banks and savings institutions—on a showing of good cause—to remove, suspend, or bar an independent accountant from performing engagements required under the FDI Act. Final interagency rules governing the agencies' authority to take disciplinary actions against independent public accountants and accounting firms was issued on August 18, 2003.

5.204 Due to the passage of Credit Union Membership Access Act of 1998 (CUMAA) in 1998, the NCUA adopted stiffer net worth requirements and prompt corrective action regulations. Practitioners should understand these regulations and their effect on the credit union.

5.205 The NCUA is required to publicly disclose formal and informal enforcement orders and any modifications to or terminations of such orders. Publication may be delayed for a reasonable time if disclosure would seriously threaten the safety or soundness of the credit union.

5.206 Currently, federal and most state credit union regulators use a letter of understanding and agreement (LUA) or similar contractual arrangement to formalize the negotiated agreement between the regulatory agency or agencies (the regional director represents the NCUA) and the credit union's board of directors concerning problems, the actions to be taken, and the timetable for completing each action. In dealing with a state-chartered, non-NCUSIF–insured credit union, the state regulator will usually involve the appropriate state or private insurer.

Planning

5.207 AU section 314 requires auditors to obtain an understanding of the entity and its environment, including its internal control. The independent accountant should obtain knowledge about regulatory matters and developments as part of the understanding of an institution's business. The independent accountant should also consider the results of regulatory examinations, as discussed above.

Detection of Errors and Fraud

5.208 AU section 316 describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement caused by fraud. Noncompliance with laws and regulations (for example, noncompliance with regulatory capital requirements) is one indicator of higher risk that is especially relevant in the industry. Events of noncompliance are often described in:

- Regulatory reports
- Cease-and-desist orders or other regulatory actions, whether formal or informal

5.209 The independent accountant has similar responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. AU section 317 defines illegal acts as violations of laws or governmental regulations and explains the independent accountant's responsibilities.

Evaluation of Contingent Liabilities and Related Disclosures

5.210 Management's financial statement assertions include those about the completeness, presentation, and disclosure of liabilities. Because some areas of regulation relate more to operations than to financial reporting or accounting, consideration of compliance in those areas would normally be limited to the evaluation of disclosures of any contingent liability based on alleged or actual violation of the law.

Going-Concern Considerations

5.211 Paragraphs 5.148–5.158 address going-concern considerations. In addition to the matters discussed in those paragraphs, the independent accountant's consideration should include regulatory matters such as:

- Noncompliance with laws and regulations
- Supervisory actions or regulatory changes that place limitations or restrictions on operating activities
- Classification of the institution under prompt corrective action provisions of the FDI Act and the FCUA (see Chapters 1 and 2)

5.212 For example, regulatory changes in 1992 placed new restrictions on the acceptance of brokered deposits by certain banks and savings institutions. This change had two implications. First, it potentially limited sources of liquidity and created a compliance requirement. An independent accountant auditing the financial statements of an institution subject to those restrictions would have needed to evaluate whether the effect on the institution's liquidity, when considered with other factors, raised substantial doubt about the institution's ability to remain a going concern for a reasonable period of time. The independent accountant would also have needed to consider the financial statement effects of any known event of noncompliance with the requirement itself. Examples of other events or conditions that would warrant the independent accountant's consideration include:

- The continued existence of conditions that brought about previous regulatory actions or restrictions
- Effects of scheduled increases in deposit insurance premiums
- Failure to meet minimum regulatory capital requirements
- Limitations on the availability of borrowings through the Federal Reserve System discount window
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities

Regulatory Accounting Practices and RAP-GAAP Differences

5.213 General purpose financial statements are prepared in accordance with GAAP. However, financial information provided to regulatory agencies may be prepared on another basis—regulatory accounting practices (RAP)—to satisfy specific regulatory objectives. Regulations require insured financial institutions to file quarterly call reports. These reports are used by regulators as a basis for supervisory action, a source of statistical information, and other such purposes. In 1997, the banking regulators adopted instructions for these reports that generally follow GAAP.

5.214 FDI Act Section 37(a)(2) requires that reports and other regulatory filings for banks and savings institutions follow accounting principles uniform and consistent with (or no less stringent than) GAAP. Regulators are permitted, for regulatory reporting purposes, however, to prescribe an accounting principle that is more stringent than GAAP if they believe that it will:

a. More accurately reflect the capital of insured banks and savings institutions.

b. Provide for more effective supervision.

c. Better facilitate prompt corrective action and least-cost resolution of troubled institutions.

5.215 With the passage of CUMAA, all federally insured credit unions with assets of $10 million or more must follow GAAP for all reports or statements required to be filed with the NCUA Board. Credit unions with assets under $10 million can use either GAAP or RAP. In addition, a credit union with over $10 million in assets could still follow RAP for supervisory committee audit regulation purposes.

5.216 Certain differences between RAP and GAAP amounts as computed for regulatory and general purpose reporting, respectively, may warrant consideration by the independent accountant. For example, the FASB's Emerging

Issues Task Force (EITF) reached a consensus on EITF Issue No. 85-44, *Differences Between Loan Loss Allowances for GAAP and RAP*, that an institution could record different loan loss allowances under RAP and GAAP because those amounts may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, independent accountants should be particularly skeptical of such RAP-GAAP differences in loan loss allowances and must justify them based on the circumstances.

5.217 Some of the other areas where accounting practices *for regulatory reporting purposes* differ from GAAP are discussed in Appendix C. Other differences are created by RAP requirements for certain reclassifications of balance sheet and income statement amounts within regulatory financial reports.

Independent Accountant and Examiner Relationship

5.218 Banking regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. There are some objectives shared by examiners and independent accountants, and coordination in consultation with the institution may be beneficial.

5.219 The primary objective of communicating with examiners is to ensure that independent accountants consider competent audit evidence produced by examiners before expressing an opinion on audited financial statements. In areas such as the adequacy of credit loss allowances and violations of laws or regulations, for example, information known to or judgments made by examiners should be made known to management and the independent accountant before financial statements are issued or an audit opinion is rendered. Such communication will minimize the possibility that a regulatory agency will subsequently require restatement—based on the examiner's additional knowledge or different judgment—of call reports and affect the general purpose financial statements, on which the independent accountant has already expressed an opinion, dated during or subsequent to the period in which a regulatory examination was being conducted.

5.220 FDI Act Section 36(h) requires that each bank and savings institution provide its independent accountant with copies of the institution's most recent call report and examination report (see 12 CFR Subpart 363.403). The institution must also provide the independent accountant with any of the following documents related to the period covered by the engagement:

a. Any memorandum of understanding (MOU) or other written agreement between the institution and any federal or state banking agency.

b. The report of any action initiated or taken by any federal or state banking agency, including any assessment of civil money penalties.

5.221 The independent accountant should review communications from examiners and, when appropriate, make inquiries of examiners. Specifically, the independent accountant should:

a. Request that management provide access to all reports of examination and related correspondence.

b. Review the reports of examination and related correspondence between examiners and the institution during the period under audit and through the date of the independent accountant's opinion.

c. With prior approval of the institution, communicate with the examiners if their examination is still in process, the institution's appeal of an examination finding is outstanding, or their examination report is still pending.

d. With prior approval of the institution, consider attending, as an observer, the exit conference between the examiner and the institution's board of directors, its executive officers, or both.

5.222 The independent accountant's attendance at other meetings between examiners and representatives of the institution requires prior approval by the regulatory agency.

5.223 Independent accountants may request a meeting with the appropriate regulatory representatives to inquire about supervisory matters relevant to the client institution. The management of the institution would generally be present at such a meeting, and matters discussed would generally be limited to findings already presented to management. Federal regulatory policy also permits meetings between examiners and independent accountants in the absence of the institution's management.[23] In addition, the OTS has established a policy that generally makes OTS examination working papers available for review.[24]

5.224 Management refusal to furnish access to reports or correspondence, or to permit the independent accountant to communicate with the examiner, would ordinarily be a limitation on the scope of a financial statement audit sufficient to preclude an opinion. Refusal by an examiner to communicate with the independent accountant may create the same scope limitation, depending on the independent accountant's assessment of the circumstances. See AU section 508.22–.26 (AICPA, *Professional Standards*, vol. 1), for additional guidance. (For a detailed discussion on reports issued under the guidance of AU section 508 and related PCAOB requirements when performing integrated audits see Chapter 22 of this Guide.)

5.225 Examiners might request permission to attend the meeting between the independent accountant and representatives of the institution (for example, the audit committee of the board of directors) to review the independent accountant's report on the institution's financial statements. If such a request is made and management concurs, the independent accountant should be responsive to the request.

5.226 Examiners and others may, from time to time, request auditors of financial statements of banks and savings institutions to provide access to working papers and audit documentation. The FFIEC's Interagency Policy Statement on External Auditing Programs for Banks and Savings Associations states that the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's working papers and other material pertaining to the institution prepared in the course of performing the completed external auditing program. On March 21, 2000, the FDIC issued guidance concerning

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[23] Related instructions to examiners were published in a July 23, 1992, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners*. On January 27, 1997 the division of Supervision of the FDIC issued a supervisory memo to encourage each region to improve communications, coordination, and working relationships with IPAs of FDIC-supervised institutions.

[24] See OTS letter to chief executive officers dated September 11, 1992.

the review of external auditor's working papers (Regional Director Memorandum No. 2000-019, "Reviews of External Auditors' Workpapers," dated March 21, 2000.) Auditors who have been requested to provide such access should refer to Auditing Interpretation No. 1 in AU section 9339 (AICPA, *Professional Standards*, vol. 1). The Interpretation provides auditors with guidance on:

- Advising management that the regulator has requested access to (and possibly photocopies of) the audit documentation and that the auditor intends to comply with the request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original audit documentation
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in AU section 9339.06 of the Interpretation.
- In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the audit documentation before the audit has been completed and the report released. Also, the Interpretation notes that if a regulator engages an independent party, such as another independent public accountant, to perform the audit documentation review on behalf of the regulatory agency, there are some precautions auditors should observe.

5.227 On February 9, 2006, the FFIEC member agencies issued the interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provision in External Audit Engagement Letters (Advisory). The Advisory informs financial institutions not to enter into audit engagement letters that incorporate unsafe and unsound limitation of liability provisions with respects to audits of financial statements and internal control over financial reporting. Generally, these provisions: (1) indemnify the external auditor against claims made by third parties (including punitive damages); (2) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution; or (3) limit the remedies available to the client financial institution.

5.228 Information in examination reports, inspection reports, supervisory discussions—including summaries or quotations—is considered confidential. Such information may not be disclosed to any party without the written permission of the appropriate agency, and unauthorized disclosure of such information could subject the independent accountant to civil and criminal enforcement actions.

Exhibit 5-1

Fraud Risk Factors

Two types of fraud are relevant to the auditor's consideration, namely, fraudulent financial reporting and the misappropriation of assets. For each type of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur, which are incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Fraudulent Financial Reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities in which specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditors should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

The following are examples of risk factors that might result in misstatements arising from fraudulent financial reporting.

Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
    - *a.* High degree of competition or market saturation, accompanied by narrowing margins shown by:
        - (1) An increase of competitor investment products that are close alternatives for the institution's deposit products (for example, mutual funds, insurance annuities, and mortgage loans), placing pressure on the institution's deposit rates
        - (2) Competitor product pricing that results in loss of customers or market share for such products as loan, deposit, trust, asset management, and brokerage offerings
    - *b.* High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates, exemplified by the following:
        - (1) A failure or inability to keep pace with or to afford rapid changes in technology, if the financial stability or profitability of the particular institution is placed at risk due to that failure or inability
        - (2) Significant unexpected volatility (for example, in interest rates, foreign exchange rates, and commodity prices) in financial markets

where the institution has a significant capital market presence and is exposed to loss of revenue or has not appropriately hedged its risk to price changes that effect proprietary positions

(3) Flattening yield curves or extremely high or low market interest rate environments

c. Significant declines in customer demand and increasing business failures in either the industry or overall economy, such as the following:

(1) Deteriorating economic conditions (for example, declining corporate earnings, adverse exchange movements, and real estate prices) within industries or geographic regions in which the institution has significant credit concentrations

(2) For credit unions, losing a very substantial portion of the membership base, which places considerable pressure on management insofar as financial projections are often based on gaining new members and offering commercial loans

d. Rapid growth or unusual profitability, especially compared to that of other peer financial institutions; for example, unusually large growth in the loan portfolio without a commensurate increase in the size of the allowance for loan and lease losses

e. New and existing accounting, statutory, or regulatory requirements, such as the following:

(1) Substantially weak CAMELS, (capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk) or, for bank-holding companies, BOPEC (bank's CAMELS rating, operation of significant nonbanking subsidiaries, parent's strength and operations, earnings of the banking organization, and capital of the banking organization) ratings.

(2) Regulatory capital requirements

f. Decline in asset quality due to:

(1) Borrowers affected by recessionary declines and layoffs

(2) Issuers affected by recessionary declines and industry factors

2. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including incentive goals:

a. Unrealistically aggressive loan goals and lucrative incentive programs for loan originations, shown by, for example:

(1) Relaxation of credit standards

(2) Excessive extension of credit standards with approved deviation from policy

(3) Excessive concentration of lending (particularly new lending)

(4) Excessive lending in new products

(5) Excessive pricing concessions not linked to enhanced collateral positions or other business rational (for example, sales of other products or services)

(6) Excessive refinancing at lower rates which may delay the recognition of problem loans

b. Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations (For example, the acquisition of another institution has been announced in the press with the terms dependent on the future financial results of the acquiring institution.)

c. Willingness by management to respond to these pressures by pursuing business opportunities for which the institution does not possess the needed expertise

d. Excessive reliance on wholesale funding (brokered deposits)

e. Speculative use of derivatives

f. Failure to establish economic hedges against key risks (for example, interest rate) through effective asset liability committee (ALCO) processes

g. Changes in a bank's loan loss accounting methodology that are not accompanied by observed changes in credit administration practices or credit conditions

h. Frequent or unusual exceptions to credit policy

i. Threat of a downgrade in the institution's overall regulatory rating (for example, CAMEL, MACRO (rating stands for management, asset quality, capital adequacy, risk management and operating results), or BOPEC) that could preclude expansion or growth plans

j. Threat of failing to meet minimum capital adequacy requirements that could cause adverse regulatory actions

3. Management's or the board of directors' personal net worth is threatened by the entity's financial performance arising from the following:

a. Heavy concentrations of their personal net worth in the entity

b. Bank is privately owned by one person or family whose net worth or income (from dividends) is dependent on the bank

Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

   a. Significant-related entity transactions not in the ordinary course of business or with related entities not audited or audited by another firm, such as the following:

      (1) Loans and other transactions with directors, officers, significant shareholders, affiliates, and other related parties, particularly those involving favorable terms

      (2) Be aware of special purpose entities (SPEs) and variable interest entities (VIEs)

      (3) Be aware of certain types of lending practices such as, subprime and predetorial lending by banks in an effort to obtain better yields

      (4) Transfers of impaired assets

   b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate (Significant estimates generally include the allowance for loan losses, and the valuation of servicing rights, residual interests, and deferred tax assets, fair value determinations, and the recognition of other impairment losses; for example, goodwill and investments)

   c. Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions, such as the following:

      (1) Consolidation questions with SPEs/VIEs

      (2) Material amounts of complex financial instruments and derivatives held by the institution that are difficult to value, or the institution's use of complex collateral disposition schemes

   d. Frequent or unusual adjustments to the allowance for loan and lease losses

   e. Loan sales that result in retained beneficial interests (Valuation of retained beneficial interests is based on estimates and assumptions and are susceptible to manipulation if not properly controlled.)

   f. Complex transactions that result in income or gains, such as sale and leasebacks, with arbitrarily short leaseback terms

   g. Deferred tax assets, arising from net operating loss carryforwards, without valuation allowances

   h. Deferral of loan origination costs that exceed the appropriate costs that may be deferred under Financial

Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*

2. Internal control components are deficient as a result of the following:

   a. Inadequate monitoring of controls, including automated controls and controls over financial reporting, such as lack of oversight of critical processes in the following areas:

      (1) Cash and correspondent banks—Reconciliation and review

      (2) Intercompany or interbranch cash or suspense accounts and "internal" demand deposit accounts—Monitoring of activity and resolution of aged items

      (3) Lending—Lack of credit committee and lack of stringent underwriting procedures

      (4) Treasury—Securities/derivatives valuation (selection of models, methodologies, and assumptions)

      (5) Regulatory compliance—Lack of knowledge of pertinent regulation

      (6) Deposits—Lack of monitoring unusual and significant activity

   b. Ineffective internal audit function

   c. Lack of board-approved credit (underwriting and administration) or investment policies

   d. Vacant staff positions remain unfilled for extended periods, thereby preventing the proper segregation of duties

   e. Lack of an appropriate system of authorization and approval of transactions in areas such as lending and investment, in which the policies and procedures for the authorization of transactions are not established at the appropriate level

   f. Lack of independent processes for the establishment and review of allowance for loan losses

   g. Lack of independent processes for the evaluation of other than temporary impairments

   h. Inadequate controls over transaction recording, including the setup of loans on systems

   i. Lack of controls over the perfection of interests in lending collateral

   j. Inadequate methods of identifying and communicating exceptions and variances from planned performance *k.* Inadequate accounting reconciliation policies and practices, including appropriate supervisory review, the monitoring of stale items and out of balance conditions, and the timeliness of writeoffs

l. Failure to establish adequate segregation of duties between approval transactions and the disbursement of funds

m. Lack of control over the regulatory reporting process, in which key decision makers also have control over the process

n. Lack of adequate reporting to the board of directors and executive management regarding credit, interest-rate, liquidity, and market risks

o. Change from an internal audit function that has been outsourced to the external auditor or other provider to a new in-house internal audit department or another outsourcing provider

Attitudes and Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations:

   a. The existence of a regulatory cease and desist order, memorandum of understanding, or other regulatory agreements (whether formal or informal), which concern management competence or internal control

   b. Repeated criticisms or apparent violations cited in regulatory examination reports, which management has ignored

2. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates:

   a. Consideration of "business issues" (for example, shareholder expectations) in determining significant estimates

   b. Adjustments to the allowance for loan losses by senior management or the board for which there is no written documentation

   c. An unusual propensity to enter into complex asset disposition agreements

3. The disregard of control-related recommendations from internal and/or external auditors

4. A high level of customer complaints (especially when management does not fix the cause of them promptly)
5. Indications that the internal audit is not adequately staffed or trained, and does not have appropriate specialized skills given the environment
6. Indications that the internal audit is not independent (authority and reporting relationships) and does not have adequate access to the audit committee (or equivalent)
7. Inappropriate scope of internal audit's activities (for example, the balance between financial and operational audits, coverage, and rotation of decentralized operations)
8. Limited authority of internal audit to examine all aspects of the client's operations or failure to exercise its authority
9. Failure by internal audit to adequately plan, perform risk assessments, or document the work performed or conclusions reached
10. Failure of internal audit to adhere to professional standards
11. Operating responsibilities assigned to internal audit
12. Inability to prepare accurate and timely financial reports, including interim reports
13. Failure of planning and reporting systems (such as business planning; budgeting, forecasting, and profit planning; and responsibility accounting) to adequately set forth management's plans and the results of actual performance
14. A low level of user satisfaction with information systems processing, including reliability and timeliness of reports
15. Understaffed accounting or information technology department, inexperienced or ineffective accounting or information technology personnel, or high turnover
16. Lack of timely and appropriate documentation for transactions
17. Dividend requirements by management or ownership frequently at or near the maximum allowable by law (In closely held companies, executive management/ownership combines high dividends with frequently substantial increases in cash salary or bonus compensation. The bank has been cited for dividend violations by regulatory authorities.)

Misappropriation of Assets

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities in which specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditor should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Risk factors that relate to misstatements arising from the misappropriation of assets are also classified along the three conditions generally present when fraud exists, namely, incentives/pressures, opportunity, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present if misstatements arising from misappropriation of assets occur. For example, the ineffective monitoring of management and weakness in internal control may be present if misstatements due to either fraudulent financial reporting or the misappropriation of assets exist. The following sections show examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives and Pressures

AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), does not require an auditor to plan the audit to discover information that indicates financial stress among employees or adverse relationships between the institution and its employees. If the auditor becomes aware of the existence of such information, he or she should consider it in addressing the risk of material misstatement arising from the misappropriation of assets.

1. Adverse relationships between the institution and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, the following may create adverse relationships:
    - *a.* It is likely that the institution will be merged into or acquired by another institution and there is uncertainty regarding the employees' future employment opportunities.
    - *b.* The institution has recently completed a merger or acquisition, employees are working long hours on integration projects, and morale is low.
    - *c.* The institution is under regulatory scrutiny, and there is uncertainty surrounding the future of the institution.
2. Members of executive management evidence personal financial distress through indications such as frequent informal "loans" or "salary advances" to key executive officers or their family members.

Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
    - *a.* Large amounts of cash on hand and wire transfer capabilities
    - *b.* Easily convertible assets, such as bearer bonds or diamonds, that may be in safekeeping
    - *c.* Inadequate or ineffective physical security controls, for example, overliquid assets or information systems
    - *d.* Access to customer accounts
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, the misappropriation of assets may occur because there is the following:
    - *a.* Inadequate management oversight of employees responsible for assets, such as:

(1) Vacant branch manager positions or managers are away on leave without replacements for an inordinate amount of time, causing a considerable lack of management oversight.

(2) The independent risk management function does not have the appropriate level of sophistication or the capability to effectively monitor and measure the risks, such as capital markets trading activities.

(3) Lack of adherence or enforcement of vacation policy.

b. Inadequate job applicant screening and/or monitoring of employees, such as:

(1) Federal Bureau of Investigation background checks, credit reports, and bonding eligibility screening are not incorporated into the hiring process for employees with access to significant assets susceptible to misappropriation.

(2) A monitoring process does not identify employees who have access to assets susceptible to misappropriation and who are known to have financial difficulties.

c. Inadequate segregation of duties and independent checks, such as:

(1) Lack of independent monitoring of activity in internal demand deposit accounts and correspondent bank accounts

(2) No independent monitoring and resolution of customer exceptions/inquiries related to electronic-funds-transfer (EFT) transactions, loan disbursements/payments, customer deposit accounts, securities and derivatives transactions, and trust/fiduciary accounts

(3) Lack of key periodic independent reconciliations (in addition to reconciliations of subledgers to the general ledger) for wire transfer, treasury, trust, suspense accounts, automated teller machines, and cash

(4) Lack of segregation of duties in the following areas:

— EFT—Origination, processing, confirmation, and recordkeeping

— Lending—Relationship management, underwriting (including approval), processing, cash collection/disbursement, and recordkeeping; no periodic confirmation of customer loan information or indebtedness by personnel independent of the relationship officer.

- — Treasury—Trading, processing, settlement, and recordkeeping. (The derivatives positions on the Treasury system are not priced by an independent operations area. The capital markets risk management process is not independent from the trading function. There is no independent confirmation of individual trades.)
- — Trust—Relationship management, transaction authorization, transaction execution, settlement, custody, and account recordkeeping. (There is no annual review of the activity in trust accounts by an investment committee to ensure compliance with the terms of the trust agreement and bank investment guidelines.)
- — Fiduciary—Issuance, registration, transfer, cancellation, and recordkeeping
- — Charged-off loan accounts and recoveries
- — Dormant and inactive demand deposit accounts (DDA) and the escheatment process.

d. No independent mailing of customer statements or monitoring of "Do not Mail/Hold" statements

e. Lack of control over new accounts

f. Failure to reconcile "due from" bank accounts on a regular basis, and review open items

g. Loans are purchased from loan brokers, but the loans are not reunderwritten before purchase

h. Inadequate segregation of duties because the institution is small and has limited staff

i. Lack of appropriate system of authorization and approval of transactions, such as:

(1) No verification of EFT initiation and authorization, including those instances in which bank employees initiate a transaction on a customer's behalf

(2) Frequent underwriting exceptions to board-established credit authorization limits

(3) Frequent instances of cash disbursements on loans that have not yet received all approvals or met all preconditions for funding

(4) Lack of board approval for significant loans or unusually high loan-officer approval limits (Be alert to the existence of multiple loans being funded just below a loan officer's limit.)

j. Poor physical safeguards over cash, investments, customer information, or fixed assets, such as:
   (1) Lack of adequate physical security over the EFT operations area and customer records
   (2) Failure to appropriately limit access to the vault to authorized employees acting within the scope of their job
   (3) Lack of dual control over the vault, negotiable instruments (including travelers' checks and money orders), and blank-check stock
   (4) Lack of accountability over negotiable instruments

k. Inadequate training of tellers and operations personnel regarding:
   (1) "Knowing your customer"
   (2) Recognizing check fraud and kiting activities
   (3) Controls over cash, negotiable instruments, and EFT

Chapter 6

Cash and Cash Equivalents[*]

Introduction

6.01 Cash and cash equivalents include cash items in the process of collection (CIPC), deposits with other financial institutions, including corporate credit unions, balances with the Federal Reserve Banks and Federal Home Loan Banks (FHLBs), federal funds sold, and cash and cash equivalents on hand. Instruments that generally meet the definition of cash and cash equivalents in FASB Statement No. 95, *Statement of Cash Flows*, are discussed in this chapter. Investments in debt and equity securities that are accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,[1,†] are discussed in Chapter 7, "Investments in Debt and Equity Securities." Other investments are discussed in Chapter 12, "Other Assets, Other Liabilities, and Other Investments."

Cash Items in the Process of Collection and Cash Equivalents

6.02 CIPC includes customer deposits drawn on other depository institutions that have not yet cleared, matured instruments (such as coupons and bonds), and other matured items temporarily held pending their liquidation. Such assets are received with deposits and other customer transactions. CIPC are eventually cleared through local clearinghouses, correspondent institutions (correspondents), or a Federal Reserve Bank. Collection of these items generally takes between one and five business days.[2] Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates, for example, short-term certificates of deposit (CDs) issued by other federally insured financial institutions.

Deposits With Other Depository Institutions

6.03 Correspondents are depository institutions that hold the account balances of other financial institutions and provide services to those institutions, such as check collection and item processing. Such accounts with balances due from other institutions are generally called "due from banks" and are maintained by depository institutions as a means of more efficient check clearing or to compensate the correspondent for other services provided to the depositor. Institutions that engage in international banking may maintain deposits with foreign depository institutions for the same reasons.

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in this FSP should be applied to reporting period beginning after December 15, 2005 with earlier application permitted.

[†] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The effective date is November 15, 2007. Entities may opt for early adoption of Statement 159, subject to conditions outlined in the Statement.

[2] Effective as of October 28, 2004, *The Check Clearing for the 21st Century Act (Check 21)* (Subpart D of Regulation CC, Expedited Funds Availability) expedited the processing of CIPCs. For additional information, see Chapter 13, "Deposits."

6.04 Many institutions also invest in nonnegotiable or negotiable certificates of deposits of other depository institutions. These balances are generally interest bearing and insured up to $100,000 and have a range of maturity options.

6.05 Many credit unions hold funds in the Corporate Credit Union Network, comprised of the U.S. Central Credit Union and all corporate credit unions. The U.S. Central Credit Union is a state-chartered, uninsured credit union cooperatively owned by the nation's corporate credit unions. It provides investment, liquidity, and payment services to corporate credit unions. Corporate credit unions often aggregate funds invested by natural person credit unions to acquire investments offered by the network. Overnight investments include regular daily shares and overnight certificates. Other offered investments, with maturities from two days to five years or longer, includes liquidity, high-yield, redeemable, and variable-rate shares and certificates.

Balances With Federal Reserve Banks and Federal Home Loan Banks

6.06 Federal regulations require depository institutions to set aside specified amounts of cash as reserves against transaction and time deposits. These reserves may be held as vault cash, in a noninterest-bearing account with a district Federal Reserve Bank or FHLB, or as deposits with correspondents. Though one objective of reserve requirements is to safeguard liquidity in the banking system, institutions do not look to their reserves as a primary source of liquidity because regulations permit their depletion for only short periods and in limited circumstances. Rather, reserves are a primary tool of the Board of Governors of the Federal Reserve System (FRB) to effect monetary policy; by increasing or decreasing reserve requirements, the FRB can expand or contract the money supply. Depository institutions also may use a Federal Reserve Bank as a correspondent bank, and lend excess balances overnight and for short periods in the federal funds market.

Cash on Hand

6.07 Cash on hand consists primarily of coin and currency in vaults, in the institution's automated teller machines (ATMs), and maintained by tellers to meet customers' requests. Cash on hand generally represents a small percentage of a depository institution's cash.

Federal Funds and Repurchase Agreements

6.08 Chapter 14, "Federal Funds and Repurchase Agreements," discusses federal funds and repurchase agreements, which can be either assets or liabilities, depending on which side of the transaction the institution participates.

Accounting and Financial Reporting

6.09 SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, paragraph 14*(a)* states that "restrictions on the use or availability of certain cash balances, such as deposits with a FHLB or correspondent financial institutions to meet reserve requirements or deposits under formal compensating balance agreements, should be disclosed in the notes to the financial statements."

6.10 SOP 01-6, paragraph 14(*b*) states that a financial institution that accepts deposits may have balances due from the same financial institution from which it has accepted a deposit. Those account balances, also called reciprocal balances, should be offset if they will be offset in the process of collection or payment. Overdrafts of such accounts should be reclassified as liabilities, unless the financial institution has other accounts at the same financial institution against which overdrafts can be offset.

6.11 The presentation of deposits in other depository institutions in the balance sheet varies among financial institutions. For example, if all or some portion of such deposits meet the definition of cash equivalent as defined in FASB Statement No. 95, some institutions may combine all or the applicable portion of deposits in other institutions with cash and cash equivalents as the first line item in the balance sheet. Any portion of deposits not meeting the definition of cash equivalent may then be shown separately in the balance sheet, or it may be combined with other short-term investments or other investments (if interest bearing); in either case, presented after cash and cash equivalents in the statement of financial condition. Alternatively, some institutions may segregate interest bearing and non-interest-bearing deposits. Non-interest-bearing deposits are typically combined with cash equivalents (assuming they meet the definition in FASB Statement No. 95), and interest-bearing deposits in other institutions are presented separately in the balance sheet after cash and cash equivalents, or combined with other short-term investments or other investments, regardless of whether all or some portion of such deposits meet the definition of cash equivalent. These practices are generally acceptable, provided that cash and cash equivalents in the balance sheet include only those instruments meeting the definition of cash equivalents, and as discussed further in paragraph 6.24, herein, the institution discloses its policy used to classify items as cash equivalents. Further, if deposits in other institutions are material, then deposits should be presented as a separate amount in the balance sheet.

6.12 Investments in negotiable certificates of deposits that meet the definition of a security in FASB Statement No. 115 are subject to the reporting, classification, and other provisions of that Statement. Investments subject to FASB Statement No. 115 are discussed in Chapter 7.[3]

6.13 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires the disclosure of fair values of financial instruments for which it is practicable to estimate fair value.[4,5] The carrying amount of items classified as cash and cash equivalents generally approximates fair value

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[3] See footnote 1 in paragraph 6.01.

[4] FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, as amended, makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

[5] FASB FSP 126-1 further clarifies the definition of public entity to include entities that are conduit bond obligors for conduit debt that is traded on a public market. Guidance based on FSP 126-1 should be applied prospectively for fiscal periods beginning after December 15, 2006.

because of the relatively short period of time between the origination of the instruments and their expected realization.

Classification of Cash Flows

6.14 FASB Statement No. 95 classifies cash receipts and disbursements into three broad categories of operating cash flows, investing cash flows, and financing cash flows.

6.15 FASB Statement No. 95 sets forth two methods of reporting cash flows from operating activities, namely, the direct method and the indirect method. The Statement encourages but does not require the use of the direct method. Under the direct method, the statement of cash flows reports the net cash flow from operating activities by showing the major classes of gross cash receipts (such as interest received and service charges collected) and gross cash disbursements (such as interest paid and operating expenses paid). If the direct method is used, FASB Statement No. 95 requires the presentation of a separate schedule to reconcile net income to the net cash flows from operating activities.

6.16 In contrast, a statement of cash flows prepared using the indirect method reports the net cash flows from operating activities by adjusting the net income for transactions reflected in net income that do not result in operating cash flows. If the indirect method is used, FASB Statement No. 95 requires the separate disclosure of interest paid (other than interest capitalized) and income taxes paid.

6.17 FASB Statement No. 102, *Statement of Cash Flows Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amended FASB Statement No. 95 by providing, among other things, that cash receipts and cash payments resulting from purchases and sales of securities classified as trading securities as discussed in FASB Statement No. 115 are to be classified as operating cash flows and that cash receipts and cash payments resulting from purchases and sales of other securities are to be classified as operating cash flows if the securities are carried at market value in a trading account. FASB Statement No. 115 amended FASB Statement No. 102 to require that cash flows from the purchases, sales, and maturities of available-for-sale securities be classified as cash flows from investing activities and reported gross in the statement of cash flows. Similarly, paragraph 9 of FASB Statement No. 102, as amended, requires that cash receipts and cash payments that result from loans originated or purchased specifically for resale are also to be classified as operating cash flows if such loans are carried at market value or at the lower of cost or market value. In applying FASB Statement No. 102, as amended, for the direct method, gross cash receipts and cash payments from these sources should be reported separately as operating cash flows. If the indirect method is used, only the net increases or decreases in these loans and securities should be reported in reconciling net income to the net cash flow from operating activities.

6.18 Cash flows from investing and financing activities must generally be reported on the basis of gross cash receipts and gross cash disbursements. However, FASB Statement No. 95 permits the net basis of reporting for the following:

- Cash and cash equivalents

- Items for which turnover is quick, amounts are large, and maturity is short; limited to those with an original maturity when purchased of three months or less, such as:
  - — Investment securities not included in cash equivalents
  - — Loans (including demand loans and credit-card loans)
  - — Time deposits, that is, certificates of deposit (CDs)
  - — Borrowings
- Items for which the institution is substantively holding, receiving, or disbursing cash on behalf of its customers, such as:
  - — Demand deposits
  - — NOW and Super NOW accounts
  - — Savings deposits
  - — Money-market-deposit accounts
  - — Mortgage escrow funds
  - — Collections and remittances on loans serviced for others

6.19 FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows From Hedging Transactions*, amended FASB Statement No. 95 to permit financial institutions to report net cash receipts and cash payments for (*a*) deposits placed with other financial institutions and withdrawals of those deposits, (*b*) CDs accepted and the repayment of those deposits, and (*c*) loans originated and principal collections on such loans. FASB Statement No. 104, also provides that cash flows from derivative instruments that are accounted for as fair value hedges or cash flow hedges under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, may be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed. FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, provides guidance on classification of cash flows for derivatives with financing elements. Specifically, the guidance now indicates that "cash flows from a derivative instrument that is accounted for as a fair value hedge or cash flow hedge may be classified in the same category as the cash flows from the items being hedged provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract) and the accounting policy is disclosed. If the derivative instrument includes an other-than-insignificant financing element at inception, all cash inflows and outflows of the derivative instrument shall be considered cash flows from financing activities by the borrower. If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows subsequent to the date of discontinuance shall be classified consistent with the nature of the instrument."

6.20 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

6.21 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. FASB Statement No. 156 amended paragraphs 21 and 56 of FASB Statement No. 133. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

6.22 Summarized below are some typical investing and financing cash flows for a financial institution.[6]

Investing Activities

Cash Inflows	*Cash Outflows*
Net loan principal payments	Net loan originations
Portfolio Loan sale proceeds	Loan purchases
Security sale and maturity proceeds (disclose separately for held-to-maturity securities and available-for-sale securities)	Security purchases (disclose separately for held-to-maturity securities and available-for-sale securities)
Real estate sale proceeds	Investment in real estate held for development
Net deposits withdrawn from other financial institutions	Net deposits placed with other financial institutions
Sales of loan servicing rights	Purchases of loan servicing rights
Net decrease in reverse repos * (repos) Decrease in NCUSIF deposit	Net increase in reverse repos (repos) Increase in NCUSIF deposit

* Repurchase agreements are addressed in Chapter 14.

Financing Activities

Cash Inflows	*Cash Outflows*
Net increase in mortgage escrow deposits	Net decrease in mortgage escrow deposits
Net CDs issued	Net CDs matured
Net increase in other deposit accounts	Net decrease in other deposit accounts

(continued)

[6] Paragraph 21 of FASB Statement No. 95 says that operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15–20 of the Statement.

Financing Activities—continued	
Cash Inflows	*Cash Outflows*
Proceeds from FHLB advances and other borrowings	Repayment of FHLB advances and other borrowings
Net increase in short-term borrowings (original maturity of three months or less)	Net decrease in short-term borrowings (original maturity of three months or less)
Proceeds from the sale of common stock or other equity instruments	Reacquisition of equity instruments (for example, purchase of treasury stock)
	Dividends and other cash distributions to stockholders
Net increase in repos and dollar repos	Net decrease in repos and dollar repos

6.23 ***Noncash Investing and Financing Activities.*** Investing and financing activities that are partially or fully noncash transactions must be reported in a related disclosure either (*a*) in narrative form in the notes to the financial statements or (*b*) in a schedule. Examples of noncash investing and financing activities for financial institutions include:

- Originating a mortgage loan to finance the sale of foreclosed real estate or real estate held for development.
- Acquiring a real estate property through, or in lieu of, foreclosure of the related loan.
- Converting mortgage or other loans into mortgage-backed or other asset-backed securities (commonly referred to as "securitizing" loans).
- Selling or purchasing branch offices when the buyer assumes deposit liabilities in exchange for loans and other assets received from the seller, in which case only the cash paid, net of cash acquired or received, should be reported as a cash outflow or inflow.
- Converting debt to equity.
- Acquiring assets under capital leases.
- Acquiring another institution using the purchase method of accounting, in which case only the cash paid in the acquisition, net of cash acquired, should be reported as a cash outflow from an investing activity and information concerning the fair value of assets acquired and liabilities assumed should be presented in the supplemental disclosure of noncash activities.

6.24 ***Definition of "Cash and Cash Equivalents."*** The beginning and ending amounts of cash and cash equivalents in the statement of cash flows should agree with the amount shown for similarly titled line items or subtotals in the balance sheet. Cash is defined to include currency on hand, demand deposits with financial institutions, and other deposit accounts with similar characteristics (that is, the ability to deposit additional funds at any time and withdraw funds at any time without prior notice or penalty). Cash equivalents are defined in FASB Statement No. 95 to include instruments that are both:

a. Short-term instruments near enough to maturity such that there is an insignificant risk of changes in market value due to changing interest rates (Short-term generally means an original maturity of three months or less. Original maturity to the purchaser is measured from the acquisition date to the maturity date. For example, a three-year U.S. Treasury note purchased three months before maturity would be a cash equivalent, whereas the same note purchased one year before maturity would not be a cash equivalent.)

b. Highly liquid instruments readily convertible to known amounts of cash

6.25 Only instruments that meet both of the above criteria and are used as part of an institution's cash-management activities should be included in cash equivalents. For example, U.S. Treasury bills purchased for an investment account would be part of the institution's investing activities (not cash-management activities) and would therefore be excluded from cash equivalents. Common examples of cash equivalents include ninety-day U.S. Treasury bills and notes, commercial paper, CDs, money-market funds, and federal funds sold.[7]

6.26 Because of the flexibility in classification, FASB Statement No. 95 requires disclosure of the policy used to classify items as cash equivalents. This disclosure is generally included in the accounting policy footnote. A change in this policy is defined as a change in accounting principle that requires a reclassification of amounts in prior years' financial statements presented for comparative purposes.

Auditing

6.27 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to cash and cash equivalents.

Objectives

6.28 The primary audit objectives for cash are to obtain reasonable assurance that:

a. Recorded balances exist and are owned by the institution.

b. Recorded balances are complete and stated at realizable amounts.

c. Balances are properly presented in the financial statements.

d. Restrictions on the availability or use of cash are appropriately identified and disclosed.

e. Cash receipts, disbursements, and transfers between accounts are recorded in the proper period.

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[7] The applicability of FASB Statement No. 115 to such items is based on whether they are securities (as defined) regardless of whether they are considered cash equivalents.

Planning

6.29 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol.1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements, which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to cash and cash equivalents. Cash and cash equivalents are generally negotiable, involve large volumes of transactions, and affect a large number of financial statement accounts.

Internal Control Over Financial Reporting and Possible Tests of Controls[8]

6.30 AU section 314, *Understanding the Entity and Its Environment and Assessing Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS). It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain a sufficient understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level. In addition to the above, when performing an integrated audit of financial statements and internal control over financial reporting, refer to AU section 319.97 for discussion on the extent of test of controls.[‡]

6.31 Because of the negotiability of the items included in cash, the large volume of activity in cash accounts, and the large number of accounts affected by cash transactions, the effectiveness of internal control in this area is an important factor in audit planning. Internal control over financial reporting and possible tests of controls related to the payments function, including wire transfers, are discussed in Chapter 13, "Deposits." Examples of control activities for cash balances include the following:

- Currency and coins are periodically counted and are reconciled to recorded amounts on a timely basis.
- Surprise counts of teller cash funds, vault cash, and cash items are performed periodically by persons other than those with related day-to-day responsibility.

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[8] See footnote 1 in Chapter 5 regarding the applicability of PCAOB standards.

[‡] In December 2006, the PCAOB proposed Release No. 2006-07, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*, and Related Other Proposals, that would supercede AS2 and all other previous PCAOB guidance related to that standard. See the PCAOB Web site at www.pcaobus.org for information about the status of this proposal.

- Tellers have exclusive access to and custody of their respective cash on hand.
- Access to night depositories (including ATM depositories) is under dual control (the control of more than one person), and at least two persons are present when the contents of depositories are removed, counted, listed, or otherwise processed.
- Cash transaction items are reviewed daily for propriety by an officer or a supervisory employee other than the custodian of the items.
- Each of the functions of draft issuance, register maintenance, and reconciliation is performed by a different employee.
- Confirmation requests received from depository institutions, supervisory examiners, and other parties are processed by an employee who does not also reconcile the subject account.
- Controls exist over access to and execution of official and certified checks.
- Controls exist over consignment items, such as traveler's checks or money orders that could easily be converted into cash.
- Cash and coin-counting equipment are periodically tested for accuracy.
- Currency that is mutilated or identified as counterfeit is segregated and reported.
- The replenishment of tellers cash is documented and reviewed by another employee.
- Vault cash is under the control of more than one person.
- Procedures exist for the credit evaluation of correspondent banking relationships.
- Records of ATM transactions are reconciled to their recording in books of entry on a daily basis.

6.32 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. The following examples of tests of controls should be considered:

- Observing that the existing segregation of duties is adequate with respect to the handling and reconciliation of cash
- Reading the documentation of surprise cash counts of teller, vault, ATM, and other cash on hand to determine whether documentation supports management's assertion that they are performed periodically and in accordance with the institution's policies
- Observing maintenance of control over mail receipts and supplies of consigned items
- Inspecting and testing reconciliations to determine that they are performed and reviewed in a timely manner

6.33 Possible tests of controls related to electronic funds transfers are discussed in Chapter 13.

Substantive Tests

6.34 The independent accountant should determine the nature, timing, and extent of substantive tests based on the assessment of risk of material misstatement. Substantive procedures that the independent accountant may consider include:

- Counting cash and comparing the balances with tellers' records
- Testing tellers' records for mathematical accuracy
- Testing the reconciliations between recorded balances of cash due from correspondents and statements received from correspondents
- Reconciling and reviewing the cutoff of interbank transfers
- Testing the reconciliations of subsidiary ledgers to the general ledger
- Testing the propriety of authorized accounts and signatures
- Reviewing the composition of suspense accounts, especially noting the recurring use and aging of reconciling items and any failure or inability to reconcile the cash account
- Confirming account balances with and reviewing the creditworthiness of correspondents
- Confirming consigned items with consignors
- Reviewing cash records for unusual transactions or adjustments
- Testing the propriety of due to and due from accounts set off in the balance sheet
- Testing fair value disclosures

Chapter 7

Investments in Debt and Equity Securities[*]

Introduction

7.01 Financial institutions acquire securities for various purposes. In addition to providing a source of income through investment or resale, securities are used to manage interest-rate and liquidity risk as part of an institution's overall asset/liability management strategies. They are also used in certain collateralized transactions. The most common securities acquired by institutions are described below. Investments that meet the definition of a security in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,[1,†] are discussed in this chapter. Other investments, including nonmarketable equity securities such as investments in Federal Home Loan Bank (FHLB) stock and Federal Reserve Bank stock, are discussed in Chapter 12, "Other Assets, Other Liabilities, and Other Investments."

7.02 There is generally a *direct* relationship between risk and return. The higher the security's risk, the higher its expected yield. An *inverse* relationship generally exists between the security's liquidity and its yield: Less liquid and longer-term securities generally have higher yields. Achieving the proper mix of safety, liquidity, and yield in an investment portfolio is one of the primary tasks of management. In managing their investment portfolios, financial institutions seek to maximize their returns without jeopardizing the liquidity the portfolios provide. Asset/liability management is discussed further in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters."

7.03 Management policies, adopted by the board of directors or its investment committee, establish authority and responsibility for investments in securities. Such policies may address investment objectives and guidelines, including specific position limits for each major type of investment, provisions for assessing risks of alternative investments, and policies on evaluating and selecting securities dealers and safekeeping agents. They also may set forth procedures for ensuring that management's investment directives are carried out and for gathering, analyzing, and communicating timely information about investment transactions.

7.04 The institution should have procedures to analyze alternative securities (including complex derivative securities which is defined as securities whose value is "derived" from that of some underlying asset(s)) according to the institution's intent, with consideration of the level of management expertise, the sophistication of the institution's control procedures and monitoring

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in this FSP should be applied to reporting period beginning after December 15, 2005.

[†] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, as an amendment to FASB Statement No. 115. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The effective date is November 15, 2007. Entities may opt for early adoption of Statement 159, subject to conditions outlined in the Statement.

systems, its asset/liability structure, and its capacity to maintain liquidity and absorb losses out of capital. For example, analyses prepared for derivative securities prior to purchase would generally include sensitivity analyses that show the effect on the carrying amount and net interest income of various interest-rate and prepayment scenarios. Such analyses may also evaluate the effect of investment securities on the institution's overall exposure to interest-rate risk. An analysis might also be performed to evaluate the reasonableness of interest-rate and prepayment assumptions provided by the selling broker, and management may obtain price quotes from more than one broker prior to executing a trade. Management may also review contractual documents to ascertain the rights and obligations of all parties to the transaction, as well as the recourse available to each party.

U.S. Government and Agency Obligations

7.05 The Department of the Treasury, as fiscal agent for the United States, routinely sells federal government debt securities called *treasuries*. Backed by the full faith and credit of the United States, treasuries are virtually free of credit risk. Because they are traded actively in a large secondary market, treasuries are highly liquid. The income they provide is generally exempt from state and local taxes. Accordingly, treasuries are used by institutions as a primary source of liquidity.

7.06 U.S. Treasury bills (T-bills) are the shortest term obligations, having original maturities of one year or less. T-bills are sold at a discount from their face value; income to T-bill investors is the difference between the purchase price and the face value. U.S. Treasury notes and bonds (T-notes and T-bonds, respectively) are longer-term obligations that pay interest in semiannual coupon payments. T-notes have original maturities between one and ten years; T-bonds have maturities of ten years or longer.

7.07 The debt of U.S. government agencies, such as the Government National Mortgage Association (GNMA or Ginnie Mae, and government-sponsored enterprises, such as the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), trades at yields slightly higher than treasury yields. The agencies and government-sponsored enterprises (GSEs) issue debentures, notes, and other debt securities having a wide variety of maturities and other features. Unlike agency debt, GSE debt is not secured by the full faith and credit of the United States. However, because the GSEs play a vital role in the nation's financial markets, many believe the Department of the Treasury would intervene before a GSE could default on its debt. Accordingly, GSE debt is perceived to have minimal credit risk.

Municipal Obligations

7.08 FASB FSP FAS 126-1, issued October 25, 2006 clarifies the definition of "Public Entity" in FASB Statements No. 69, *Disclosures about Oil and Gas Producing Activities*; No. 109, *Accounting for Income Taxes*; No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*; No. 131, *Disclosures about Segments of an Enterprise and Related Information*; No. 132 (revised 2003), *Employers' Disclosures about Pensions and other Post Retirement Benefits*; and No. 141, *Business Combinations*. FSP 126-1 also clarifies the definition of "Public Entity" in AICPA Audit and Accounting Guides, *Health Care Organizations* and *Not-for-Profit Organizations*.

7.09 As stated in FSP 126-1, any government entity that offers a debt security (for example a bond) in which the proceeds are not for its own use, is said to have issued a conduit debt security. A private party (conduit debt obligator) receives the debt proceeds, but is also liable for all fund payments and interest as they become due.

7.10 FSP 126-1 includes the above debt obligators as public entities if they are liable for bonds (or other securities) that are traded on a public market (domestic or foreign). The guidance in FSP 126-1 should be applied prospectively in fiscal periods beginning after December 15, 2006. An entity may apply retrospective application for all prior periods. If an entity issues interim financial statements, this FSP shall be applied to the first interim period after the date of adoption.

7.11 State and local governments and their agencies (such as housing, school, or sewer authorities) issue notes and bonds of various maturities. Many municipal bonds are callable: They may be redeemed by the municipality before the scheduled maturity date. Tax anticipation notes, so named under the expectation that they will shortly be repaid with tax receipts, generally mature within one year and are usually purchased directly from the government at a negotiated price. Revenue and bond anticipation notes are similarly issued and retired with certain expected revenues or proceeds from the expected sale of bonds. Municipal bonds may be either general obligation (that is, backed by the full taxing authority of the issuer) or limited obligation (that is, used to finance specific long-term public projects, such as building a school). Municipal bonds are purchased through a competitive bidding process or in the secondary market.

7.12 Municipal obligations vary significantly in risk. Credit quality depends heavily on the ability and willingness of the municipality to service its debt or the profitability of the particular project being financed. Liquidity also varies. A number of municipal obligations are traded actively; others are thinly traded. Interest on most municipal obligations is exempt from taxes in the state of the municipality; exemption from federal income taxes depends on the extent to which the obligations benefit private parties rather than the public. (See paragraph 16.11 for additional discussion of tax-exempt income.)

Asset-Backed Securities

7.13 Asset-backed securities (ABSs) are sometimes referred to as derivative securities in that they are repaid with cash flows derived from other financial assets (such as mortgage loans or credit-card receivables).[2]ABSs provide

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[2] FASB Statement No. 133, as amended, established the accounting and reporting standards for derivative instruments and for hedging activities. Some ABSs may be subject to the requirements of FASB Statement No. 133, embedded derivative instruments, based on paragraphs 12–14 of that Statement. The Derivatives Implementation Group (DIG) Statement 133 Implementation Issue No. D1 entitled, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," provides further guidance on paragraph 14 of FASB Statement No. 133, as amended. Issues addressed by the DIG and the status of related guidance can be found at the FASB's Web site at www.fasb.org. Paragraph 10(i) of FASB Statement No. 133, as amended, states that "The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement.

In February of 2006, the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140.* FASB Statement No. 155 resolves issues addressed in FASB Statement No. 133 Implementation

(continued)

a great level of liquidity to financial markets, allow for a wide variety of innovative products, and, because they often involve incrementally more risk, offer better yields than treasuries.

7.14 ABSs are highly versatile because cash flows from the underlying assets can be reconfigured through any number of structures for repayment to ABS investors. ABSs allow the issuer to enhance the marketability of the underlying assets, for example, by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those investors willing to accept a higher concentration of the risks associated with specific cash flows from the collateral.

7.15 This chapter focuses on ABSs from the perspective of the security holder. Chapters 10, "Transfers of Loans and Mortgage Banking Activities;"and 15, "Debt," discuss matters unique to depository institutions that issue ABSs.

7.16 A given ABS structure generally involves any number of investment classes (or tranches) with various degrees of risk and reward. Among other common characteristics, ABSs:

- Are issued by both governmental and private issuers, including banks and savings institutions.
- Generally include some form of credit enhancement to limit the credit risk of the underlying assets. For example, an issuer or third party may guarantee that the ABS principal and interest will be repaid as scheduled regardless of whether cash is received from payments on the underlying collateral.
- Are often issued in book-entry form. That is, no physical certificates change hands; rather, ownership is recorded on the investor's account.

7.17 The largest volumes of ABSs issued are backed by real estate mortgage loans (mortgages) and are called mortgage-backed securities (MBSs). Other types of collateral that have been used in ABS issuances include credit-card receivables, treasuries, car loans, recreational vehicle loans, and mobile home loans. MBSs and other mortgage securities are discussed below to provide examples of risk characteristics and other matters that may be encountered with various forms of ABSs and their collateral.

7.18 ***Mortgage-Backed Securities.*** The simplest form of ABS is the basic (or *plain vanilla*) MBS, created by pooling a group of similar mortgages. Most MBSs are issued with a stated minimum principal amount and interest rate and

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(footnote continued)

Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," along with amendments and additions to paragraph 14 of FASB Statement No. 133. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of FASB Statement 65, are not subject to FASB Statement No. 133. In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement." In other words, commitments to originate mortgage loans that will be held for sale are considered derivatives under the scope of FASB Statement No. 133, as amended, for the issuers (but not holders) of such commitments.

represent a pro rata share in the principal and interest cash flows to be received as the underlying mortgages are repaid by the mortgagors. The mortgages underlying the issuance typically have:

a. The same type of collateral, such as single-family residential real estate

b. Fixed or adjustable interest rates within a specified range

c. Maturities within a specified range

7.19 ***Risk Characteristics of MBSs.*** Because the repayment of MBSs is contingent on repayment of the underlying loans, the risk characteristics of specific MBS issuances are driven by the risk characteristics of the loans. For example, underlying mortgages insured by the Federal Housing Administration (FHA) would typically involve less credit risk than unguaranteed conventional mortgages.

7.20 ***More Complex MBS Structures.*** More complex MBS structures concentrate or dilute risk to create a range of possible investments with unique risks and rewards. As described below, one must understand the structure and nature of a specific mortgage-backed security to understand the related risks.

7.21 ***Credit Risk.*** To make a particular issuance of MBS more attractive to potential investors, the credit risk associated with mortgages underlying MBS is generally reduced by the issuer or third party through some form of *credit enhancement*, such as:

a. A letter of credit

b. Guarantee of scheduled principal or interest payments, often achieved through a transaction with a federal agency such as Ginnie Mae, or a GSE such as Freddie Mac or Fannie Mae

c. Guarantee of all or a portion of scheduled principal and interest payments through insurance of the pool by a private mortgage insurer

d. Overcollateralization of the issuance, where cash flows from the excess collateral are used to make up for delinquent collateral payments

e. A senior/subordinated (senior/sub) structure, in which one group of investors holds a subordinated interest in the pool by accepting all or a large portion of the related credit risk in return for a greater yield

7.22 The degree of protection from credit risk offered by the various types of credit enhancement must be considered in relation to the characteristics of the collateral and, therefore, is unique to each security. Further, when credit risk is addressed through a credit enhancement, the security holder is still at risk that the third-party guarantor or private insurer could default on its responsibility. (The risk that another party to a transaction will default on its obligations under the transaction is referred to as *counterparty risk*.) Many MBS issuances carry credit ratings assigned by an independent rating agency.

7.23 ***Interest-Rate Risk and Prepayment Risk.*** The overall return—or yield—earned on a mortgage depends on the amount of interest earned over the life of the loan and the amortization of any premium or discount. Mortgage yields, therefore, are highly sensitive to the fact that most mortgages can be repaid before their scheduled maturity date without penalty. Although the owner of a mortgage receives the full amount of principal when prepaid, the interest income that would have been earned during the remaining period to maturity—net of any discount or premium amortization—is lost.

7.24 As with individual mortgages, the actual maturities and yields of MBSs depend on when the underlying mortgage principal and interest are repaid. If market interest rates fall below a mortgage's contractual interest rate, it is generally to the borrower's advantage to prepay the existing loan and obtain new financing at the new, lower rate. Accordingly, prepayments may be estimated to predict and account for the yield on MBSs.

7.25 In addition to changes in interest rates, actual mortgage prepayments depend on other factors such as loan types and maturities, the geographical location of the related properties (and associated regional economies), seasonality, age and mobility of borrowers, and whether the loans are assumable, as are certain loans insured by the FHA or guaranteed by the Department of Veterans' Affairs (VA).

7.26 Some MBSs are backed by adjustable-rate mortgages (ARMs). Interest rates on ARMs change periodically based on an independent factor plus an interest-rate spread, which is expressed as a specified percentage (1 percent, also referred to as one *point*) or one one-hundredth of a percentage (.01 percent, also referred to as one *basis point*). For example, an ARM might carry a rate that changes every six months based on the average rate on one-year treasuries plus two points. Annual increases in an ARM's interest rate are generally capped, as are total interest-rate increases over the life of the loan.

7.27 Although yields on ARMs tend to follow increases in prevailing interest rates, they also follow interest rate declines. This, and the fact that many ARMs are often issued with *teaser* rates that are significantly below market rates as a way to attract borrowers, make it more difficult to predict the overall risk of investments in ARM MBSs. The frequency of interest-rate adjustments, the index, the initial interest rate, and the annual and lifetime caps all should be considered. For example, credit risk may be higher for ARM MBSs because when interest rates rise borrowers' ability to pay is diminished as their monthly payments increase.

7.28 Changes in the indexed rates of certain ARMs lag behind changes in prevailing rates. When interest rates are falling, adjustable-rate MBSs generally trade at a premium, although frequently they are prepaid as borrowers seek to lock in lower fixed rates. Conversely, when interest rates are rising, adjustable-rate MBSs generally trade at a discount.

7.29 ***Other Mortgage-Backed Securities.*** Other MBSs add layers of complexity to the security structure to create investment classes that meet the needs of and are attractive to potential investors. Security holders find certain investment classes attractive because they can purchase the cash flows they desire most, or can synthetically create a security with the desired interest rate and prepayment characteristics. As discussed above, MBSs offer pro rata shares in principal and interest cash flows with stated principal amounts and interest rates, and subject to credit, prepayment, and other risks. More complex MBSs are used to further restructure the cash flows and risks so that investment classes may be offered that feature:

- Different anticipated maturities
- A single final payment (called a zero-coupon class) rather than monthly, quarterly, or semiannual installments
- Floating interest rates, even though the underlying assets have fixed rates
- Repayment on a specified schedule, unless mortgage prepayments go outside a prescribed range (called a *planned amortization class* or PAC)
- Protection against faster but not slower prepayments (called a *targeted amortization class*, or TAC)
- Rights to interest cash flows only, called *interest-only securities* (IOs), or to principal cash flows only, called *principal-only securities* (POs)
- Rights only to those cash flows remaining after all other classes have been repaid (a *residual interest* or *residual*)

7.30 These and other specialized classes—and the fact that many MBSs use pools of MBSs rather than pools of mortgages as collateral—make analysis of investments in mortgage-backed securities complex. Accordingly, such instruments could expose an institution to substantial risk if not understood or effectively managed by the institution.

7.31 Two common forms of multiclass MBSs are collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). CMOs are bonds secured by (and repaid with) the cash flows from collateral MBSs or mortgages and generally involve some form of credit enhancement. The collateral is generally transferred to a special-purpose entity (SPE) or qualified special purpose entity (QSPE), which may be organized as a trust, a corporation, or a partnership. The SPE is an entity created by an asset transferor or sponsor to carry out a specific purpose, activity or series of transactions directly related to its specific purpose. The SPE or QSPE then becomes the issuer of the CMO. Accordingly, a security holder may invest in a CMO in equity form (for example, trust interests, stock, and partnership interests) or nonequity form (for example, participating debt securities). REMICs are a form of CMO specially designated for federal income tax purposes so that the related income is taxed only once (to the security holder). See Chapter 16, "Income Taxes." Readers may also refer to FIN No. 46(R) (revised December 2003), *Consolidation of Variable Interest Entities*, and related FASB Financial Staff Positions (FSPs), for further guidance.

7.32 Understanding the risks associated with a particular tranche of a MBS or other ABS often requires an understanding of the security structure, as documented in the offering document and related literature. A tranche is defined as one of several related securities offered at the same time. Tranches from the same offering usually have different risk, reward, and/or maturity characteristics.

7.33 ***Risk Analysis.*** A discussion of the risks associated with every possible form of MBS or other ABS is beyond the scope of this Audit and Accounting Guide (Guide). A basic understanding of the relationship between interest and principal cash flows, in addition to an understanding of related risks (such as credit risk), is needed to analyze investments in MBSs. The discussion below uses IOs, POs, and residuals as examples of ABS classes for this purpose. The discussion of the senior/sub structure used in some issuances also highlights the importance of understanding the structure and the form of credit enhancement when evaluating an investment in mortgage derivatives or other ABSs.

7.34 Investment classes that have a contractual right to interest cash flows (interest classes), such as MBS IOs, are extremely interest-rate sensitive and, therefore, carry the risk that the security holder's entire recorded investment could be lost. Investment classes weighted toward principal cash flows (principal classes), such as MBS POs, also carry special risks. The discussion below of related risk concepts can be applied to various other investments in MBSs or other ABSs.

7.35 ***Interest Classes and IOs.*** Interest classes receive all, or substantially all, of the interest cash flows from the underlying collateral mortgages. Accordingly, they have been found to be useful vehicles for managing the interest-rate risk inherent in mortgage portfolios, because prepayments cause the value of IOs to move in the opposite direction from that of mortgages and traditional fixed-income securities. However, because of the sensitivity of IOs to interest rates, the recorded investment in an IO may be lost if actual prepayments are higher than anticipated.

7.36 Changes in the prices (and, therefore, the values) of MBSs are heavily dependent on whether collateral's interest rates are above or below prevailing interest rates. A mortgage will trade at a discount (a discount mortgage) when it carries an interest rate lower than prevailing interest rates. A mortgage that carries an interest rate above prevailing rates will trade at a premium (a premium mortgage).

7.37 An IO backed by a pool of premium mortgages may be a more useful tool for controlling interest-rate risk than one backed by a pool of discount mortgages, as it shows greater appreciation in value when interest rates increase and does not suffer as significant a decrease in value when interest rates fall. Falling interest rates generally result in greater prepayments. Accordingly, the cash generated from an IO over its life usually decreases because interest is earned on a smaller remaining principal balance. Although the discounting of the stream of interest receipts at a lower interest rate increases the present value of each future dollar of interest, the negative effect of increased prepayments generally outweighs the positive discounting effect, and, therefore, the fair value of the IO generally declines. IOs generally increase in value in a rising rate environment because as prepayments slow, the related mortgage principal balance remains outstanding for a longer period, and, therefore, interest is earned for a longer period (although the present value of each of those future dollars is reduced by the higher discount rate).

7.38 ***Principal Classes and POs***. Principal classes are often issued at deep discounts from the contractual principal amount because the security holder receives no interest. In contrast to zero-coupon bonds, whose entire principal amount is paid at maturity, the principal amount of POs is paid periodically according to repayment of the underlying mortgage principal. If the security holder has the ability to hold the PO to maturity, only credit risk or counterparty default would prevent ultimate recovery of the recorded investment. The fair value of a PO is also dependent on the effects of prepayments and discounting, both of which are dependent on interest rates.

7.39 The fair value of a PO tends to increase as prepayments accelerate, because the security holder receives the return of principal more quickly. Conversely, as prepayments slow, the value of the PO tends to decline. A PO backed by discount mortgages tends to appreciate more as interest rates fall than would a PO backed by premium mortgages. However, when interest rates rise, a PO backed by discount mortgages would not decline in value as much as a PO backed by premium mortgages. The difference in fair values reflects the relationship between prepayment rates and the stated interest rates on the collateral backing the POs. Prepayments on discount POs are generally significantly lower than prepayments on premium POs. As interest rates decline, prepayments on both types of POs will accelerate. However, prepayments on premium POs do not increase as much, because prepayments on these instruments are usually already at a high level. Conversely, when interest rates rise, prepayments on underlying discount mortgages do not slow significantly, because they are usually already at a relatively low level, but prepayments on underlying premium mortgages decline sharply.

7.40 A decline or increase in interest rates similarly causes the present value of cash flows from POs to increase or decrease, respectively, because of related changes in the discount rate used to determine the present value of any future cash flows.

7.41 Because POs generally increase in value in response to declining interest rates, they are sometimes used to manage the interest-rate risk associated with investments in mortgage servicing rights, CMO or REMIC residuals, and IOs. However, institutions in liability-sensitive positions (that is, institutions whose liabilities will reprice more quickly than their assets) would be negatively affected by an increase in interest rates, and, therefore, the use of POs to manage the interest-rate risk of such assets may be counterproductive because such a strategy may increase the institution's overall exposure to interest-rate risk.

7.42 ***Residual Classes.*** From a legal perspective, residuals represent an ownership interest in the underlying collateral, subject to the first lien and indenture of the other security holders. Residuals entitle the holder to the excess, if any, of the issuer's cash inflows (including reinvestment earnings) over cash outflows (which often include any debt service and administrative expenses). There are typically three sources of residual cash flows:

a. The differential between interest cash flows on the collateral and interest payments on other investment classes

b. Any overcollateralization provided as a credit enhancement

c. Any income earned on reinvestment of other cash flows before they are distributed to other security holders (because payments on collateral mortgages are received monthly but some investment classes are repaid quarterly or semiannually, these receipts are reinvested in the interim)

7.43 Residuals are often designed to reduce the prepayment risk of other classes and to provide security holders with the potential for high yields. Residuals may earn high yields if prepayments of the underlying collateral are not greater than the rate assumed at the time the issuance was structured and sold. Residuals are particularly sensitive to prepayments, and the residual holder's recorded investment may be lost entirely if actual prepayments are higher than anticipated. As with POs and IOs, residuals may contain credit risk and their fair values are dependent on the effect of discounting.

7.44 Although other investment classes may receive triple-A credit ratings, residuals are usually not rated, because they are so susceptible to interest-rate risk. Even if a residual is rated triple-A, such a rating often indicates only that the rating agency expects that the minimum required payments of principal, interest, or both will be received (that is, that credit risk is perceived to be low), not that a security holder will realize the anticipated yield.

7.45 As with other investment classes, the return on and fair value of a residual is dependent on the underlying collateral, the security structure, and its performance under varying interest-rate and prepayment scenarios. Residuals sometimes carry fixed- or floating-interest rates.

7.46 The fair value of fixed-rate residuals typically increases as interest rates increase and decreases as interest rates decline. The main source of cash flow on a fixed-rate residual comes from the interest differential between the interest payments received on the underlying collateral mortgages and the interest payments made on other investment classes. Because short-term classes usually carry lower interest rates than longerterm classes, residual cash flows from the interest differential tend to be greatest in earlier years after issuance, before the short-term classes have been repaid. Accordingly, the longer the lower-rate classes remain outstanding, the greater the cash flow accruing to the residual class. As interest rates decline, prepayments accelerate, the interest differential narrows, and overall cash flows decline. Conversely, as interest rates climb, prepayments slow, generating a larger cash flow to residual holders.

7.47 The fair value of floating-rate residuals usually performs best in a stable interest-rate environment. As with fixed-rate residuals, the main source of cash flow to floating-rate residuals is the interest differential between interest earned on the collateral and interest paid on other investment classes. However, because one or more of the classes is tied to a floating rate, the interest differential changes when the rates on floating-rate classes are reset. For example, when interest rates rise, the rate on the floating-rate class may be reset at a higher rate. More of the cash flows from the underlying collateral would then be paid to the floating-rate classes, leaving less cash flow for the residual. Higher interest rates also tend to cause prepayments to slow, and thereby increase the period over which the interest-differential income is earned by the residual holders. Conversely, when interest rates decline, rates on floating-rate classes decrease, but prepayments of premium mortgages would tend to accelerate. The loss of interest income as a result of prepayments would typically offset a widening of the interest differential stemming from the lower rate on the floating-rate class, thus reducing the cash flow to the residual. Thus, changes in interest rates produce two opposing effects on the fair value of floating-rate residuals. Whether the value of the residual actually declines or rises when interest rates change depends on the interrelationship between the interest on the floating-rate class and mortgage prepayment speeds.

7.48 ***Senior/Sub Securities.*** The senior/sub form of credit enhancement is often used for conventional mortgages. A senior/sub issuance generally divides the offered securities into two risk classes, namely, a senior class and one or more subordinated classes. The subordinated classes, often retained by the sponsor of the ABS, provide credit protection to the senior class. When cash flows on the underlying mortgages are impaired, the cash is first directed to make principal and interest payments on the senior-class securities. Furthermore, some cash receipts may be held in a reserve fund to meet any future shortfalls of principal and interest to the senior class. The subordinated classes may not receive debt-service payments until all of the principal and interest payments have been made on the senior class and, where applicable, until a specified level of funds has been contributed to the reserve fund.

7.49 Subordinated classes generally carry higher interest rates and are often unrated because of the higher credit risk. Accordingly, subordinated classes are not usually purchased to be held to maturity. The fair value of subordinated securities, like the fair value of other MBSs, depends on the nature of the underlying collateral and how changes in interest rates affect cash flows on the collateral. The fair value would also reflect any reserve fund priorities and the increased credit risk associated with the securities.

Issues of International Organizations and Foreign Governments

7.50 International financial institutions and foreign governments and their political subdivisions increasingly rely on international capital markets for funds. A significant portion of international debt securities is denominated in U.S. dollars. The credit risk and liquidity risk vary for different issues, though many are high quality and widely traded. Institutions have also obtained foreign debt securities of financially troubled countries in troubled debt restructurings; such securities are generally lower quality and not widely traded.

Other Securities

7.51 Other securities held by depository institutions, where permitted by applicable laws and regulations, include the following:

- Common-trust or mutual-investment funds
- Investments in negotiable certificates of deposit
- Equity securities, including venture capital investments
- Corporate bonds and commercial paper

The credit quality and risk of these instruments are unique to the particular issuance. The financial strength of the issuer and other counterparties is a major determinant and may be evidenced by an investment rating.

Corporate Credit Union Shares and Certificates

7.52 The Corporate Credit Union Network (the Network) serves as a primary investment alternative for many credit unions. The Network consists of the U.S. Central Credit Union and the various corporate credit unions. U.S. Central "wholesales" financial and payment services to the corporate credit unions, which in turn act as financial intermediaries on behalf of the individual credit unions. Surplus funds of the individual credit unions may be aggregated in the corporate credit unions for investment through U.S. Central. U.S. Central's investment objectives are to offer competitive yields on investments while maintaining safety and liquidity. Overnight investment alternatives offered through the Network include regular daily shares and overnight certificates. Term investment alternatives, with maturities of two days to five years and longer, offered through the Network include (*a*) liquidity, (*b*) high-yield and redeemable shares, and (*c*) variable-rate shares and certificates.

Transfers of Securities

7.53 ***Short Sales.*** *Short sales* are trading activities in which an institution transfers securities it does not own, with the intention of buying or borrowing securities at an agreed-upon future date to cover the transfer. Securities are "sold short" for protection against losses, for short-term borrowing of funds, for arbitrage, or in anticipation of a decline in market prices.

7.54 ***Borrowing and Lending Securities.*** Sometimes an institution will borrow securities from a counterparty or from its trust customers' assets when the institution is obligated to deliver securities it does not own. Examples are in a short sale, to settle a repurchase agreement (repo), or because a counterparty may have failed to deliver securities the institution needed for delivery to another counterparty.) The institution, therefore, uses borrowed securities to fulfill its obligation until it actually receives the securities it has purchased. Institutions also may loan securities to a counterparty.

7.55 An institution may advance cash, pledge other securities, or issue letters of credit as collateral for borrowed securities. The amount of cash or other collateral required may increase or decrease depending on changes in the value of the securities.

Regulatory Matters

7.56 Federal laws and regulations place certain restrictions on the types of financial instruments that an institution may deal in, underwrite, purchase, and sell. Transactions in certain securities, such as those backed by the full faith and credit of the United States, are generally unrestricted. Holdings of other securities—of any one obligor—are generally limited based on capitalization. Restrictions on dealing in or underwriting in the security may also apply. Additional restrictions may apply to state-chartered institutions.

7.57 ***Banks and Savings Institutions.*** In Thrift Bulletin (TB) 73a, the OTS states that trust preferred securities (TPSs) that otherwise meet the requirements of corporate debt securities are permissible investments for federal savings associations. They are, however, prohibited from purchasing TPSs or any other type of security from the parent holding company or any other affiliate. TB 73a should be consulted for additional limitations and requirements for holding these securities. National banks and state nonmember banks are permitted to invest in trust preferred stock within certain limitations. (See OCC Interp. Letter No. 777, April 8, 1997; FDIC Financial Institution Letter 16-99, February 16, 1999).

7.58 The Federal Financial Institutions Examination Council (FFIEC) issued a supervisory policy statement dated April 23, 1998, that was adopted by all of the federal banking agencies, on investment securities and end-user derivative activities. The policy statement provides guidance to financial institutions on sound practices for managing the risks of investment securities and end-user derivatives activities. The guidance describes the practices that a prudent manager normally would follow, but it emphasizes that it is not intended to be a checklist and management should establish practices and maintain documentation appropriate to the institution's individual circumstances.

7.59 The guidance applies to all securities in held-to-maturity and available-for-sale accounts as described in FASB Statement No. 115 certificates of deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other ABSs, and MBSs products. Similarly, the guidance covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options.

7.60 This policy describes sound principles and practices for managing and controlling the risks associated with investment activities. Institutions should fully understand and effectively manage their investment activities. The policy emphasizes that failure to understand and adequately manage the risks in these areas constitutes an unsafe and unsound practice.

7.61 Board of director and senior management oversight is an integral part of an effective risk management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. Senior management is responsible for the daily management of an institution's investments. Institutions with significant investment activities should ensure that back-office, settlement, and transaction reconciliation responsibilities are conducted or managed by personnel who are independent of those initiating risk taking positions.

7.62 An effective risk management process for investment activities includes (1) policies, procedures, and limits; (2) the identification, measurement, and reporting of risk exposures; and (3) a system of internal control. The policy statement identifies sound practices for managing specific risks involved in investment activities. These risks include:

- Market risk
- Credit risk
- Liquidity risk
- Operational (transaction) risk
- Legal risk

In addition, institutions are reminded to follow any specific guidance or requirements from their primary supervisor related to these activities.

7.63 On December 13, 1999, the federal banking agencies jointly released the Interagency Guidelines on Asset Securitization that highlight the risks associated with asset securitization and emphasize the agencies' concerns with certain retained interests generated from the securitization and sale of assets. The guidelines set forth the supervisory expectation that the value of retained interests in securitizations must be supported by objectively verifiable documentation of the assets' fair market value, utilizing reasonable, conservative valuation assumptions. Retained interests that do not meet such standards or that fail to meet the supervisory standards outlined in the guidance will be disallowed as assets of the bank for regulatory capital purposes. The guidance stresses the need for bank management to implement policies and procedures that include limits on the amount of retained interests that may be carried as a percentage of capital. Institutions that lack effective risk management programs or engage in practices deemed to present other safety and soundness concerns may be subject to more frequent supervisory review, limitations on retained interest holdings, more stringent capital requirements, or other supervisory response.

7.64 ***Credit Unions.*** Federal regulations describe investments allowed for federal credit unions. These regulations explicitly prohibit federal credit unions from (*a*) purchasing stripped MBSs, residual interests in CMOs and REMICs, mortgage servicing rights, commercial-mortgage-related securities, or small-business-related securities, (*b*) purchasing a zero-coupon investment with a maturity date that is more than 10 years from the settlement date, (*c*) purchasing or selling financial derivatives, futures, options, swaps or forwards except for certain put options on Ginnie Mae, Federal National Home Mortgage Association (Fannie Mae), and Freddie Mac MBSs, and (*d*) engaging in adjusted trading or short sales.[3]

7.65 Federally insured state-chartered credit unions are required under terms of the insurance agreement to establish an investment valuation reserve (displayed as an appropriation of retained earnings) for nonconforming investments. Nonconforming investments are those investments permissible under state law for a state-chartered credit union, but which are impermissible for federally chartered credit unions.

Accounting and Financial Reporting

7.66 FASB Statement No. 115 addresses accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities.[4,5,†] Paragraph 6 of FASB Statement No. 115 requires that those investments be classified in three categories. Paragraphs 7 and 12 of the Statement specify the accounting for securities classified in each of the three categories as follows:

a. Held-to-maturity securities (only those debt securities for which the institution has the positive intent and ability to hold to maturity) are reported at amortized cost.[6]

b. Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near term) are reported at fair value, with unrealized gains and losses included in earnings.[7]

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[3] Part 7.42 of the NCUA Rules and Regulations. Credit unions who qualify for the Regulatory Flexibility Program (Reg-Flex) can be subject to less strict regulation in this area. Currently Reg-Flex qualifying credit unions can purchase zero coupon investments beyond ten years of maturity.

[4] See paragraph 137 of FASB Statement No. 115 for related definitions of security, debt security, and equity security.

[5] The FASB also published a FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*.

[†] See footnote † in paragraph 7.01.

[6] Paragraph 7 of FASB Statement No. 115, as amended, and FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, says a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. A debt security with those characteristics should be evaluated in accordance with paragraphs 12–16 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. See footnote 2 in paragraph 7.13 for additional information regarding the issuance of an amendment to FASB Statement No. 133.

[7] MBSs that are held for sale in conjunction with mortgage banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended) are classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process. (See FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*).

c. Available-for-sale securities (debt and equity securities that are not classified as either held to maturity or trading) are reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.[8]

7.67 FASB Statement No. 130, *Reporting Comprehensive Income*, requires that all components of comprehensive income be displayed with the same prominence as other financial statements that constitute a full set of financial statements. The Statement divides comprehensive income into net income and other comprehensive income. Paragraph 17 of the Statement requires that items included in other comprehensive income be classified based on their nature and recognizes, for example, that under existing accounting standards, other comprehensive income includes unrealized gains and losses on certain investments in debt and equity securities. Paragraph 18 of the Statement requires that adjustments be made to avoid double counting in comprehensive income items that are displayed as part of net income for a period that also had been displayed as part of other comprehensive income in that period or earlier periods. For example, gains and losses on investment securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains and losses in the period in which they arose must be deducted through other comprehensive income of the period in which they are included in net income to avoid including them in comprehensive income twice.

7.68 Paragraph 8 of FASB Statement No. 115 addresses changes in circumstances that may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity.

7.69 For individual securities classified as either available for sale or held to maturity, paragraph 16 of FASB Statement No. 115 requires institutions to determine whether a decline in fair value below the amortized cost basis is other than temporary.[9] (If a security has been the hedged item in a fair value hedge, the security's "amortized cost basis" shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133.) For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt

[8] Paragraph 36 of FASB Statement No. 109, *Accounting for Income Taxes*, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in other comprehensive income. Specifically, paragraph 36(b) of FASB Statement No. 109 says that the tax effects of gains and losses that occur during the year and are included in comprehensive income but excluded from net income (for example, changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115) are charged or credited directly to the related component of shareholders' equity.

[9] When addressing other than temporary impairment, readers may also refer to Emerging Issues Task Force Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and the FASB Staff Position (FSP) FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. See footnote 1 in paragraph 7.01 for additional information.

security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).[10] The new cost basis shall not be changed for subsequent recoveries in fair value.[‡]

7.70 Paragraph 15 of FASB Statement No. 115 specifies accounting for transfers between categories.

7.71 FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, clarifies that any loan that was restructured in a troubled debt restructuring involving a modification of terms, including those restructured before the effective date of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, would be subject to the provisions of FASB Statement No. 115 if the debt instrument meets the definition of a security (as provided in FASB Statement No. 115).

Premiums and Discounts

7.72 An institution will often pay less (or more) for a security than the security's face value.[11] Accretion of the resulting discount (or amortization of the premium) increases (or decreases) the effective rate of interest on the security, thereby reflecting the security's market yield. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, specifies that discounts or premiums associated with the purchase of debt securities should be accreted or amortized using the interest method, that is, to arrive at periodic interest income at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase discount or premium).

7.73 The period of amortization or accretion for debt securities should generally extend from the purchase date to the maturity date, not an earlier call date. Paragraph 19 of FASB Statement No. 91 permits expected maturity dates to be used only for holdings of large numbers of similar loans for which prepayments are probable and the timing and the amount of the prepayments can be reasonably estimated. Certain ABSs may meet those conditions,

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[10] A decline in the value of a security that is other than temporary is also discussed in AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), and Codification of Staff Accounting Bulletins, Topic 5(m): *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*.

[‡] FASB Statement No. 157, *Fair Value Measurements*, clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. A fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset. That guidance applies for stock with restrictions on sale that terminate within one year that is measured at fair value under FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. FASB Statement No. 157, *Fair Value Measurements*, also clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

[11] FASB Statement No. 115 does not affect the methods used for recognizing and measuring the amount of dividend and interest income (see paragraph 14 of FASB Statement No. 115).

and institutions should consider estimates of prepayments in determining the amortization period for calculation of the constant yield. If the institution anticipates prepayments in applying the interest method and a difference arises between the anticipated prepayments and the actual prepayments received, the effective yield should be recalculated to reflect actual payments to date and anticipated future payments. The net investment should be adjusted to the amount that would have existed had the new effective yield been applied since purchase. The investment should be adjusted to the new balance with a corresponding charge or credit to interest income. Readers may also refer to EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*,[||] for additional guidance.

7.74 ***POs.*** In general, purchase discounts on POs are recognized by the interest method over the contractual life of the related instrument in conformity with FASB Statement No. 91. However, POs ordinarily meet the criteria in paragraph 19 of FASB Statement No. 91 that permit the accretion of discounts using expected maturity dates.

Special Areas

7.75 FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003 FIN No. 46(R),[12,13] clarified the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which

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[||] The FASB updated the status section of this EITF Issue to reflect the issuance of the FASB's Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments*—an amendment of FASB Statement No. 133 and 140.

[12] Application of FIN No. 46(R) is required for <u>public entities</u> that have interests in entities that are commonly referred to as variable interest entities. Application by <u>small business issuers</u> to *variable interest entities* other than *special-purpose entities* and by <u>nonpublic entities</u> to all types of *variable interest entities* was required at various dates in 2004 and 2005.

[13] The FASB issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs are applied in accordance with the effective date and transition provisions of FIN 46(R). FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 replaced FIN 46-2, FIN 46-5, and FIN 46-8, respectively.

5. FSP FIN 46(R)-5 "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities" (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.)* For entities to which Interpretation 46(R) has been applied, the guidance in this FSP applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) was permitted but not required. Early application was permitted for periods

(continued)

equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. FIN No. 46 (R) may impact financial institutions by adding assets and debt back onto the balance sheet, increasing capital levels. VIEs may appear in various forms, such as trust preferred securities (TPSs), synthetic leases, asset-backed commercial paper conduits, and collateralized debt obligations. FIN No. 46(R) does not apply to the transferor of a qualified special-purpose entity covered by paragraph 35 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, or to grandfathered special-purpose entities. Asset-backed or mortgage-backed securities that were transferred to a qualifying SPE are exempt from FIN No. 46(R) unless the holder of the security has the unilateral ability to cause the entity to liquidate or to change the entity such that it no longer meets the criteria of paragraph 25 or 35 of FASB Statement No. 140.

7.76 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. The Statement amends paragraphs 35(c) and 40 of FASB Statement No. 140. Statement No. 155 amends paragraph 35(c) of Statement 140 to clarify passive derivative financial instruments that pertain to beneficial interests issued or sold to parties other than the transferor, its affiliates, or its agents. Statement 155 amends paragraph 40 of Statement 140 by the removal of the phrase "other than another derivative instrument". This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

7.77 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. This Statement amends FASB Statement No. 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

7.78 As listed below, several specialized accounting issues involving investments have been addressed by the FASB's Emerging Issues Task Force (EITF).

(footnote continued)

for which financial statements have not yet been issued. For entities to which Interpretation 46(R) had not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).

6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*."Effective for all arrangements to which FIN 46 has been or will be applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change should be reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).

7.79 ***Loan Conversions.*** EITF Issue No. 94-8, *Accounting for Conversion of a Loan Into a Debt Security in a Debt Restructuring*, addresses accounting for such conversions.

7.80 ***Sales of Marketable Securities With Put Arrangements.*** As discussed beginning in paragraph 7.82, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,[‡] addresses transfers of financial assets, including marketable securities. Transfers of marketable securities with put arrangements are further addressed in EITF Issues No. 84-5, *Sale of Marketable Securities With a Put Option*, and No. 85-25, *Sale of Preferred Stocks With a Put Option*.

7.81 ***Mutual Funds.*** Accounting for investments in certain mutual funds is addressed in EITF Issue No. 86-40, *Investments in Open-End Mutual Funds That Invest in U.S. Government Securities*.

7.82 ***Investments Required to Be Divested.*** EITF Issue No. 89-18, *Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity Under FIRREA* (as amended by FASB Statement No. 115), addresses accounting for such securities.

7.83 EITF Issue No. 89-18 did not address accounting for the subsequent sale of the securities to an affiliate or accounting in consolidated financial statements; however, the SEC staff observer at the EITF meeting noted that gain recognition would not be appropriate when the securities are sold to an affiliate. Further, paragraph 6 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, states that consolidated financial statements should not include gain or loss on transactions among the companies in the group.

7.84 EITF Issue No. 89-18, as amended, requires that investments in securities required to be divested should be reported as available for sale at fair value (see paragraph 7.77). The fair value for these securities can be difficult to determine, depending on the availability of third-party quotations that are limited at times because of a lack of market activity in these securities. Junk bonds, for example, are often issued by companies without long track records of sales and earnings, by established companies the profitability of which has declined, or by entities with questionable credit. Additionally, junk bonds have been used to finance leveraged corporate acquisitions in which the assets of the company being acquired serve as collateral for the securities. Institutions have been attracted to the potentially higher yields on junk bonds relative to higher-grade bonds.

7.85 Readers may want to read EITF Topic D-74 in Appendix D, *Issues Concerning the Scope of the AICPA Guide on Investment Companies*. This Appendix discusses some of the FASB's concerns about the scope of the AICPA Audit and Accounting Guide *Investment Companies*.[#]

[‡] See footnote ‡ in paragraph 7.69.

[#] In April of 2006 the Auditing Standards Board (ASB) issued SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*, which was effective on issuance. This SOP supersedes SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Standards*, and amends specific paragraphs contained in the AICPA Audit and Accounting Guide on *Investment Companies*. In addition, the Accounting Standards Executive Committee (AcSEC) has issued an exposure draft of a Statement of Position (SOP), *Clarification of the Scope of the*

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Transfers and Servicing of Securities[14]

7.86 FASB Statement No. 140 provides accounting and reporting standards for transfers and servicing of financial assets, including securities.[15] The Statement is based on consistent application of a *financial-components approach* that focuses on control. FASB Statement No. 140 describes that, under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB Statement No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

7.87 Under FASB Statement No. 140, as amended by FASB Statement No.155, *Accounting for Certain Hybrid Instruments*, and FASB Statement No.156, *Accounting for Servicing Financial Assets*, (see paragraphs 7.78 and 7.79) a transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. Paragraph 9 of the Statement says a transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28 of the Statement give related guidance).[16]

b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35[‡] of the Statement), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange

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(footnote continued)

Audit and Accounting Guide Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. The proposed SOP provides specific conditions for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under the SOP, the SOP also addresses the retention of that specialized industry accounting by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (referred to as an equity method investor). Readers should be alert to the final issuance.

[14] Readers should also refer to Chapter 10, "Transfers of Loans and Mortgage Banking Activities," for additional guidance regarding Transfers and Servicing of Securities.

[15] The FASB has published a Special Report entitled *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Questions and Answers—Fourth Edition* (cumulative) in February 2001. In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*, and several questions and answers in this Special Report on FASB Statement No. 140 were affected. See footnote ‡ in paragraph 7.72 for additional information.

[16] In July 2001, the Financial Accounting Standards Board issued FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*, which addressed the transition questions to the application of those provisions from the previous isolation standards and practices established under FASB Statement No. 125. The Technical Bulletin is effective upon issuance.

[‡] See footnote ‡ in paragraph 7.69.

and provides more than a trivial benefit to the transferor (paragraphs 29–34 of the Statement).

c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47 through 49 of the Statement) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50 through 54 of the Statement).

7.88 Paragraph 10 of FASB Statement No. 140, as amended by FASB Statement No. 156, requires that, upon completion of any transfer of financial assets, the transferor shall:

a. Initially recognize and measure at fair value, if practicable (paragraph 71), servicing assets and servicing liabilities that require recognition under the provisions of paragraph 13.

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests that continue to be held by the transferor, if any, based on their relative fair values at the date of transfer (paragraphs 56 through 60 of the Statement).

c. Continue to carry in its statement of financial position any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying SPE in a securitization (paragraphs 73–84), and any undivided interests (paragraphs 58 and 59).

7.89 Paragraph 11 of FASB Statement No. 140 requires that, upon completion of a transfer of financial assets that satisfies the conditions to be accounted for as a sale (paragraph 7.82), the transferor (seller) shall:

a. Derecognize all assets sold.

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing assets and servicing liabilities, if applicable (paragraphs 56, 57, and 61 through 67 of the Statement give related guidance).

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 68 through 70 of the Statement) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 71 and 72 of the Statement).

d. Recognize in earnings any gain or loss on the sale.

7.90 Paragraph 11 of FASB Statement No. 140 requires that the transferee recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

7.91 If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9 of FASB Statement No. 140 (paragraph

7.82), paragraph 12 of the Statement requires that the transferor and transferee account for the transfer as a secured borrowing with pledge of collateral (see paragraph 7.89 herein).

7.92 ***Recognition and Measurement of Servicing Assets and Liabilities.*** Paragraph 13 of FASB Statement No. 140, as amended by FASB Statement No. 156, requires that an entity shall recognize and initially measure at fair value, if practicable, a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

a. A transfer of the servicer's financial assets that meets the requirements for sale accounting

b. A transfer of the servicer's financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates

An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing liabilities or report those servicing assets or servicing liabilities together with the asset being serviced.

FAS Statement No. 140, as amended by FASB Statement No. 156, adds paragraphs 13A and 13B. Paragraph 13A states that an entity shall subsequently measure each class of servicing assets and servicing liabilities using one of the following methods:

a. *Amortization method:* Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues), and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

b. *Fair value measurement method:* Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value of servicing assets and servicing liabilities in earnings in the period in which the changes occur.

The election described in this paragraph shall be made separately for each class of servicing assets and servicing liabilities. An entity shall apply the same subsequent measurement method to each servicing asset and servicing liability in a class. Classes of servicing assets and servicing liabilities shall be identified based on (*a*) the availability of market inputs used in determining the fair value of servicing assets or servicing liabilities, (*b*) an entity's method for managing the risks of its servicing assets or servicing liabilities, or (*c*) both. Once an entity elects the fair value measurement method for a class of servicing assets and servicing liabilities, that election shall not be reversed (paragraph 63).

> If it is not practicable to initially measure a servicing asset or servicing liability at fair value, an entity shall initially recognize the servicing asset or servicing liability in accordance with paragraph 71 and shall include it in a class subsequently measured using the amortization method.
>
> 13B states that an entity shall report recognized servicing assets and servicing liabilities that are subsequently measured using the fair value measurement method in a manner that separates those carrying amounts on the face of the statement of financial position from the carrying amounts for separately recognized servicing assets and servicing liabilities that are subsequently measured using the amortization method. To accomplish that separate reporting, an entity may either (*a*) display separate line items for the amounts that are subsequently measured using the fair value measurement method and amounts that are subsequently measured using the amortization method or (*b*) present the aggregate of those amounts that are subsequently measured at fair value and those amounts that are subsequently measured using the amortization method (paragraph 63) and disclose parenthetically the amount that is subsequently measured at fair value that is included in the aggregate amount.

7.93 *Financial Assets Subject to Prepayment.* Paragraph 14 of FASB Statement No. 140 requires that, except for those instruments that are within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of FASB Statement No. 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, as amended (paragraph 362 of the Statement). A debt security with those characteristics should be evaluated in accordance with paragraphs 12–16 of FASB Statement No. 133[17] to determine whether it contains an embedded derivative that must be accounted for separately. Readers should refer to Derivatives Implementation Group Statement 133 Implementation Issue No. D1, *Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*, for additional guidance on paragraph 14 of FASB Statement No. 133, as amended.

7.94 ***Secured Borrowings and Collateral.*** Paragraph 15 of FASB Statement No. 140 says:

> A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same

[17] See footnote 2 in paragraph 7.13.

relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately, (for example, as security pledged to creditors) from other assets not so encumbered.

b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of FASB Statement No. 140.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 15(c), the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

7.95 Paragraphs 91 through 95 of FASB Statement No. 140 discuss application of the Statement to securities lending transactions. Application of the Statement to repos and wash sales is discussed in paragraphs 96 through 101 of the Statement.

7.96 ***Other Issues.*** Topic D-66 in Appendix D to the *EITF Abstracts* discusses the effect of an SPE's powers to sell, exchange, repledge, or distribute transferred financial assets under FASB Statement No. 140. Topic D-69[**] in Appendix D discusses gain recognition on transfers of financial assets under FASB Statement No. 140.

7.97 Topic D-44 in Appendix D to the *EITF Abstracts* includes a discussion of when an institution should recognize an other-than-temporary impairment if it has decided to sell a specifically identified available-for-sale debt security at a loss shortly after the reporting date.

7.98 ***Trade Date Accounting.*** As referenced in SOP 01-6, paragraph 10(a), "Regular-way purchases and sales of securities should be recorded on the trade date. Gains and losses from regular-way security sales or disposals

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[**] The FASB updated the status section of Topic D-69 in Appendix D to the EITF Abstracts to reflect the issuance of the FASB's Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statement No. 133 and 140*. For additional information see footnote ‡ in paragraph 7.75.

should be recognized as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of."[18]

7.99 ***Short Sales.*** As referenced in SOP 01-6, paragraph 10(b), "The obligations incurred in short sales[19] should be reported as liabilities and adjusted to fair value through the income statement at each reporting date. Such liabilities are generally called securities sold, not yet purchased. The fair value adjustment should be classified in the income statement with gains and losses on securities. Interest on the short positions should be accrued periodically and reported as interest expense."

7.100 ***Offsetting.*** Balances arising from secured borrowings should be reported gross on the balance sheet unless the provisions of FASB Interpretation No. 39, *Offsetting Amounts Related to Certain Contracts*, are met. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, does not apply to secured borrowings.

Troubled Debt Restructurings

7.101 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, applies to troubled debt restructurings involving debt securities, including instances in which there is a substitution of debtors. FASB Statement No. 114, as amended, sets forth accounting for troubled debt restructurings involving a modification of terms of a receivable. This topic is discussed in more detail in Chapter 8, "Loans." Readers may also refer to EITF Issues No. 01–7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*, and 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement No. 15*, for additional guidance.

Amortization of Discounts on Certain Debt Securities

7.102 The Accounting Standards Executive Committee (AcSEC) issued AICPA Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, as an amendment to Practice Bulletin No. 6, *Amortization of Discounts of Certain Acquired Loans*, to provide accounting guidance for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004. (In addition, SOP03-3 applies to problem loans acquired individually, in a portfolio, or in acquisition. SOP 03-3 does not apply to any entity's originated loans, or acquired loans without evidence of credit quality deterioration. This topic is discussed in more detail in Chapter 8, "Loans.

Financial Statement Presentation and Disclosure

7.103 The notes to the financial statements should include an explanation of the institution's accounting policy for securities, including the basis for classification.

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[18] Chapter 10, paragraph 10.15 of this Guide discusses accounting for transfers of loans that have not been previously securitized.

[19] Paragraph 59(d) of FASB Statement No. 133, as amended, discusses short sales.

7.104 Paragraphs 19 and 20 of FASB Statement No. 115,[21] as amended, require that the following information about held-to-maturity and available-for-sale securities be disclosed separately for each of those categories:

a. For securities classified as available-for-sale, all reporting enterprises shall disclose the aggregate fair value, the total gains for securities with net gains in accumulated other comprehensive income, and the total losses for securities with net losses in accumulated other comprehensive income, by major security type as of each date for which a statement of financial position is presented. For securities classified as held-to-maturity, all reporting enterprises shall disclose the aggregate fair value, gross unrealized holding gains, gross unrealized holding losses, the net carrying amount, and the gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities, by major security type as of each date for which a statement of financial position is presented.

Major security types include, but are not limited to, the following:

- Equity securities
- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- Debt securities issued by states within the United States and political subdivisions of the states
- Debt securities issued by foreign governments (including those classified as loans)
- Corporate debt securities
- MBSs
- Other debt securities

b. Information about the contractual maturities of securities as of the date of the most recent statement of financial position. Maturity information may be combined in appropriate groupings.[22] These disclosures should include the fair value and net carrying amount (if different than fair value) of debt securities based on at least the four following maturity groupings:

- Within one year
- After one year through five years
- After five years through ten years
- After ten years

7.105 For each period for which the results of operations are presented, paragraph 21 of FASB Statement No. 115, as amended, requires that the institution disclose:

a. The proceeds from sales of available-for-sale securities and the gross realized gains and gross realized losses that have been included in earnings as a result of those sales

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[21] See footnote 9 in paragraph 7.69.

[22] Securities not due at a single maturity date, such as MBSs, may be disclosed separately rather than allocated over several maturity groupings; if allocated, the basis for allocation should be disclosed.

b. The basis on which cost of a security sold or the amount reclassified out of accumulated other comprehensive income into earnings was determined (that is, specific identification, average cost, or other method used)

c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category

d. The amount of the net unrealized holding gain or loss on available-for-sale securities for the period that has been included in accumulated other comprehensive income and the amount of gains and losses reclassified out of accumulated other comprehensive income into earnings for the period.[23]

e. The portion of trading gains and losses for the period that relates to trading securities still held at reporting date

7.106 For any sales of or transfers from securities classified as held to maturity, paragraph 22 of FASB Statement No. 115, as amended, requires the net carrying amount of the sold or transferred security, the net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security, the related realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the security to be disclosed in the notes to the financial statements for each period for which the results of operations are presented. Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in FASB Statement No. 115, subparagraphs 8(a)–8(f), or sales that are considered maturities in accordance with the criteria in paragraph 11.

7.107 FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, as amended, requires all entities to disclose the fair value of financial instruments for which it is practicable to estimate fair value. In addition FASB Statement No. 107 requires disclosure of significant concentrations of credit risk for all financial instruments.[24] The concentrations-of-credit-risk disclosures apply to debt securities as well as loans. FASB Statement No. 107 disclosures are discussed further in paragraphs 8.114 through 8.117. (Off-balance-sheet risk disclosures are discussed in Chapters 8 and 18, "Futures, Forwards, Options, Swaps, and Similar Financial Instruments.")

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[23] FASB Statement No. 109, *Accounting for Income Taxes*, requires that income tax expense or benefit for the year be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (such as changes in the unrealized holding gains and losses of securities classified as available for sale [see Chapter 16]).

[24] FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an Amendment of FASB Statement No. 107*, as amended, amended FASB Statement No. 107 to make disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133 other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

7.108 FASB Statement No. 140 paragraph 17[††] as amended by FASB Statement 156, requires the institution to disclose the following:

a. For collateral:
   (1) If the entity has entered into repos or securities lending transactions, and its policy for requiring collateral or other security
   (2) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 15(a) of FASB Statement No. 140, the carrying amount and classification of those assets as of the date of the latest statement of financial position presented
   (3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, *Extinguishment of Debt*, prior to the effective date of Statement 125, 6 a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding.

c. If assets are set aside after the effective date of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets.

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in the transfers of financial assets during the period, a description of those items, and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:
   (1) Management's basis for determining its classes of servicing assets and servicing liabilities (paragraph 13A).
   (2) A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities. (Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required.)

[††] Paragraphs 17, 63, and footnotes 20 and 21 in paragraph 69 of FASB Statement No. 140 have been amended by the issuance of the FASB's Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. See paragraph to 7.73 for additional information regarding the issuance and adoption of this and other amendments to FASB Statement No. 140 along with a related exposure draft and FASB Staff Position.

(3) The amount of contractually specified servicing fees (as defined in the glossary), late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

f. For servicing assets and servicing liabilities subsequently measured at fair value:

(1) For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

(a) The beginning and ending balances

(b) Additions (through purchases of servicing assets, assumptions of servicing obligations, and servicing obligations that result from transfers of financial assets)

(c) Disposals

(d) Changes in fair value during the period resulting from:

(i) Changes in valuation inputs or assumptions used in the valuation model

(ii) Other changes in fair value and a description of those changes

(e) Other changes that affect the balance and a description of those changes

(2) A description of the valuation techniques or other methods used to estimate the fair value of servicing assets and servicing liabilities. If a valuation model is used, the description shall include the methodology and model validation procedures, as well as quantitative and qualitative information about the assumptions used in the valuation model (for example, discount rates and prepayment speeds). (An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing assets and servicing liabilities, as encouraged by paragraph 17(e)(2), is also encouraged, but not required, to disclose a description of the valuation techniques, as well as quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.)

g. For servicing assets and servicing liabilities subsequently amortized in proportion to and over the period of estimated net servicing income or loss and assessed for impairment or increased obligation:

(1) For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in the carrying amount are

reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:

(a) The beginning and ending balances

(b) Additions (through purchases of servicing assets, assumption of servicing obligations, and servicing obligations that result from transfers of financial assets)

(c) Disposals

(d) Amortization

(e) Application of valuation allowance to adjust carrying value of servicing assets

(f) Other-than-temporary impairments

(g) Other changes that affect the balance and a description of those changes

(2) For each class of servicing assets and servicing liabilities, the fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period if it is practicable to estimate the value.

(3) A description of the valuation techniques or other methods used to estimate fair value of the servicing assets and servicing liabilities. If a valuation model is used, the description shall include the methodology and model validation procedures, as well as quantitative and qualitative information about the assumptions used in the valuation model (for example, discount rates and prepayment speeds). (An entity that provides quantitative information about the instruments used to manage the risks inherent in the servicing assets and servicing liabilities, as encouraged by paragraph 17(e)(2), is also encouraged, but not required, to disclose a description of the valuation techniques as well as quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.)

(4) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63.

(5) The activity by class in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and recoveries credited to operations, and aggregate write-downs charged against the allowance—for each period for which results of operations are presented.

h. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

(1) Its accounting policies for initially measuring the interests, that continue to be held by the transferor, , and servicing assets and servicing liabilities, if any including the

methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (see paragraphs 68 through 70 of FASB Statement No. 140)

(2) The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on interests that continue to be held by the transferor) and the gain or loss from sale of financial assets in securitizations

(3) The key assumptions[25] used in measuring the fair value of interests that continue to be held by the transferor and servicing assets or servicing liabilities, if any at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets,[26] and anticipated credit losses, if applicable)

(4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained that continue to be held by the transferor)

i. If the entity has interests that continue to be held by the transferor in financial assets that it has securitized or servicing assets or servicing liabilities relating to assets that it has securitized, at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

(1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (see paragraphs 68 through 70 of FASB Statement No. 140)

(2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses,[27] if applicable)

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[25] If an entity has made multiple securitizations of the same major asset type during a period, it may disclose the range of assumptions.

[26] The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

[27] Expected static poll losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

(3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under item 2 above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test

(4) For the securitized assets and any other financial assets that it manages together with them:[28]

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period

(b) Delinquencies at the end of the period

(c) Credit losses, net of recoveries, during the period

Disclosure of average balances during the period is encouraged, but not required.

7.109 SOP 01-6[‡‡] states that the carrying amount of investment assets that serve as collateral to secure public funds, securities sold under repos, and other borrowings, that are not otherwise disclosed under FASB Statement No. 140, should also be disclosed in the notes to the financial statements. Insurance subsidiaries may be required to deposit securities with state regulatory authorities. If so, the carrying amount of securities deposited should be disclosed.

Auditing

Objectives

7.110 The primary objectives of audit procedures in this area are to obtain reasonable assurance that:

a. Securities, accrued interest, and discounts and premiums of the institution:

- Exist at the balance-sheet date (definitive securities are on hand or held by others in custody or safekeeping for the account of the institution) and are owned by the institution.
- Have been properly classified, described, and disclosed in the financial statements at appropriate amounts (including consideration of any other-than-temporary declines in value and disclosure of any securities pledged as collateral for other transactions).

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[28] Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.

[‡‡] In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. As a result, the language in SOP 01-6, paragraph 8(h), was revised to remove reference to paragraph 10(b) of FASB Statement No. 140. See paragraph 7.73 for additional information.

b. Sales of securities and other transactions that:

- Have been recorded occurred during the given period.
- Should be presented in the financial statements are so included.

c. Realized and unrealized gains and losses, and interest (including premium amortization and discount accretion), dividend, and other revenue components:

- Have been included in the financial statements at appropriate amounts.
- Are properly classified, described, and disclosed.

Planning

7.111 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent auditor should obtain audit evidence about the factors influencing the risks of material misstatements, are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to financial statement assertions related to investments. The primary inherent risks—interest-rate risk, credit risk, and liquidity risk—are interrelated. For example, increases in market interest rates may affect other risk factors by decreasing marketability (that is, liquidity) or by increasing the credit risk of the issuer's obligations. The independent auditor should have an understanding of the relationship between the interest-rate environment and the market values of securities. The institution's asset/liability and other risk management policies may provide useful information about the possible effects of interest rate and liquidity risks on the institution's securities.

7.112 Another risk inherent to complex investments is the business risk that the institution does not properly understand the terms and economic substance of a significant complex investment. Such misunderstandings could result in the incorrect pricing of a transaction and improper accounting for the investment or related income. (Related guidance on learning the extent of derivatives use is given in Chapter 18.) Inquiry of a specialist[29] should be considered by the independent accountant if a financial institution may have engaged in holding or trading such complex securities.

7.113 Classification of investments in securities among the held-to-maturity, available-for-sale, and trading categories is important because it directly affects the accounting treatment. The classification of securities, which must occur at acquisition, should be consistent with the institution's investment, asset/liability, and other risk management policies. The independent auditor should ascertain whether the accounting policies adopted by the entity for investments are in conformity with generally accepted accounting principles (GAAP). In planning the audit, the independent auditor should consider

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[29] Auditors should refer to Auditing Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," in AU section 9336.01–.21, *Using the Work of a Specialist: Auditing Interpretations of Section 336* (AICPA, *Professional Standards*, vol. 1) for guidance on dealing with legal opinions on FASB Statement No. 140.

reading the current year's interim financial statements, investment policy, and other financial information related to securities. The level of inherent risk for securities varies widely from institution to institution depending on, among other things, the nature and complexity of the securities and the extent and effectiveness of the institution's accounting and operational policies and procedures, as well as management's understanding and awareness of the risks. The following factors related to securities may, considered in the aggregate, indicate higher inherent risk:

a. Significant concentrations of credit risk with one counterparty or within one geographic area

b. Significant use of complex securities, particularly without relevant in-house expertise

c. Excessively high volumes of borrowing or lending of securities

d. Relatively high volatility in interest rates

e. Changes in the terms of government guarantees

f. Actual prepayment experience that differs significantly from that anticipated

g. Declines in the values of collateral underlying securities

h. Changes in guarantors' claims processing

i. Significant conversion options related to the collateral (for example, variable to fixed rates)

j. Sales and transfers from the held-to-maturity securities portfolio

k. Uncertainty regarding the financial stability of an ABS servicer or of guarantors

l. Uncertainty regarding the financial stability of a safekeeping agent or other third party holding the institution's securities

m. Changes in accounting systems, including software and manual processes

Internal Control Over Financial Reporting and Possible Tests of Control

7.114 AU section 314, *Understanding the Entity and Its Environment and Assessing Risks of Material Misstatements* (AICPA, *Professional Standards*, vol. 1), as amended, provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. AU section 314.40 requires that, in all audits, the independent accountant obtain a sufficient understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to evaluate the design of internal controls and 2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risk material misstatements at both the overall financial statement level and at the assertion.

7.115 Effective internal control, as it relates to financial reporting of investments in securities, should provide reasonable assurance that:

a. Management's policies are adequate to provide for financial reporting in accordance with GAAP.

b. Physical securities are on hand or held in custody or safekeeping by others in accordance with management's authorization.

c. Misstatements caused by error or fraud in the processing of accounting information for investments in securities are prevented or detected, and corrected in a timely manner.

d. Securities are monitored on an ongoing basis to determine whether recorded financial statement amounts require adjustment.

7.116 Control activities that would contribute to internal controls over financial reporting in this area include the maintenance of management policies, adopted by the those charged with governance or its investment committee, that establish authority and responsibility for investments in securities.

7.117 Other control activities that contribute to strong internal control over financial reporting of securities include the following:

- Procedures exist to identify and monitor credit risk, prepayment risk, and impairment.
- Those charged with governance—generally through an investment committee—oversees management's securities activities.
- Accounting entries supporting securities transactions are periodically reviewed by supervisory personnel to ensure that classification of securities was made and documented at acquisition (and date of transfer, if applicable) and is in accordance with the institution's investment policy and management's intent.
- Recorded securities are periodically reviewed and compared to safekeeping ledgers and custodial confirmations, on a timely basis, including immediate and thorough investigation and resolution of differences and appropriate supervisory review and approval of completed reconciliations.
- Current fair values of securities are obtained and reviewed on a timely basis.
- Securities loaned to other entities or pledged as collateral are designated as such in the accounting records.
- Lists of authorized signers are reviewed and updated periodically, and transaction documentation is compared to the authorized lists.
- There is appropriate segregation of duties among those who (*a*) execute securities transactions, (*b*) approve securities transactions, (*c*) have access to securities, and (*d*) post or reconcile related accounting records.
- Buy and sell orders are routinely compared to brokers' advices.
- Adjustments to securities accounts (for example, to recognize impairments) are reviewed and approved by the officials designated in management's policy.

- Periodic tests of interest and dividend income are performed by reference to supporting documentation, which may include using analytical procedures commonly referred to as yield analysis. (With this approach, actual yields during the period are compared to expected yields based on previous results and current market trends. Any significant differences should be investigated and explained.)
- Securities are monitored on an ongoing basis and factors affecting income recognition and the carrying amount of the securities are analyzed periodically to determine whether adjustments are necessary.

7.118 Many of the control activities for securities are often performed directly by senior management. While management's close attention to securities transactions can be an effective factor in internal control, the independent accountant should be alert to potential abuses and override of policies and procedures when such circumstances exist.

7.119 ***Audits Performed in Accordance With PCAOB Standards.*** Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 for a discussion on the extent of test of controls (AICPA, *PCAOB Standards and Related Rules*). Also, refer to Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing decisions.

7.120 The independent accountant also should consider the guidance of AU section 328,[30] *Service Organizations* (AICPA, *Professional Standards*, vol. 1), if the institution obtains services from another organization that are part of its information system. When performing an integrated audit, refer to Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards").

7.121 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. In such circumstances, the auditor should test internal controls. Examples of tests of controls that might be considered include:

- Reading minutes of meetings of the board of directors (and any investment committee) for evidence of the board's periodic review of securities activities made so that the board may determine adherence to the institution's policy.

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[30] The ASB issued an Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*. The Guide includes illustrative control objectives as well as Interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers. Readers should be aware of the guidance in this Guide.

- Comparing securities transactions, including transfers, to the institution's accounting policy to determine whether the institution is following its policy. For example, the independent accountant may include:
  - Testing that transactions have been executed in accordance with authorizations specified in the investment policy.
  - Evaluating evidence that securities portfolios and related transactions (including impairments) are being monitored on a timely basis and reading supporting documentation.
  - Testing recorded purchases of securities, including that classification of the securities and prices and entries used to record related amounts (for example, use of trade versus settlement date, and treatment of commissions, premiums and discounts).
- Recalculating a sample of premium and discount amortization amounts and gains and losses on sales.
- Reviewing controls over accumulating information necessary for financial statement disclosures.
- Testing the reconciliation process. The independent accountant might test whether reconciling differences are investigated and resolved and whether the reconciliations are reviewed and approved by supervisory personnel.
- Examine evidence that the company takes physical inventory and confirms safekeeping on a periodic basis, including reconciliation of differences.

Substantive Tests

7.122 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to investments in debt and equity securities.

7.123 In addition, AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in planning and performing further audit procedures for relevant assertions related to investments in securities, as well as derivative instruments and hedging activities. Chapter 6, "Designing Substantive Procedures Based on Risk Assessments," of the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides detailed guidance and recommendations about designing and performing substantive procedures at the assertion level. Readers should follow that guidance when designing and performing substantive tests.

7.124 In addition, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP.[31]

[31] For additional guidance refer to AICPA Interpretation No. 1 of AU section 328, and Interpretation No. 1 of AU section 332, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," and "Auditing Investments in Securities Were a Readily Determinable Fair Value Does Not Exist," respectively.

Chapter 8

*Loans**

Introduction

8.01 Loans usually are the most significant assets of financial institutions and generate the largest portion of revenues. Like investments, an institution's management of its loans is an integral part of its asset/liability management strategy (discussed in Chapter 1, "Industry Overview—Banks and Savings Institutions"). Institutions originate loans, purchase loans or participating interests in loans, sell loans or portions of loans, and securitize loans (the latter two activities are discussed in Chapter 10, "Transfers of Loans and Mortgage Banking Activities"). The composition of loan portfolios differs considerably among institutions because lending activities are influenced by many factors, including the type of institution, management's objectives and philosophies regarding diversification and risk (credit strategy), the availability of funds, credit demand, interest-rate margins, and regulations. Further, the composition of a particular institution's loan portfolio may vary substantially over time.

The Lending Process

8.02 To plan and design audit procedures properly, the independent accountant needs to understand the institution's loan portfolio, lending processes, loan accounting policies, market specialty, and trade area, as well as other factors such as economic conditions. This section discusses certain characteristics of and considerations involved in the lending process. The specific features will vary from institution to institution.

Credit Strategy

8.03 The institution's credit strategy includes its defined goals and objectives for loans, as well as the loan policies written to help achieve those goals and objectives. A guiding principle in credit strategy is to achieve profitable returns while managing risk within the loan portfolio. Credit strategy and policy are usually determined by senior management and approved by the board of directors.

8.04 The objectives of a sound credit plan are to identify profitable markets, set goals for portfolio growth or contraction, and establish limits on industry and geographic concentrations. The plan establishes the institution's credit underwriting standards. In addition, management procedures and controls are required to monitor loan performance through periodic reporting and review and to identify and monitor problem loan situations.

Credit Risk

8.05 The overriding factor in making a loan is the amount of credit risk associated with the loan in relation to the potential reward. For individual

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* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

loans, credit risk pertains to the borrower's ability and willingness to pay; it is assessed before credit is granted or renewed and periodically throughout the loan term.

8.06 An institution's credit exposure may be affected by external factors, such as the level of interest rates, unemployment, general economic conditions, real estate values, and trends in particular industries and markets. Internal factors—such as an institution's underwriting practices, credit practices, training, risk management techniques, familiarity and experience with its loan products and customers, the relative mix and geographic concentration of its loan portfolio and the strength of its internal control—also have a significant effect on an institution's ability to control and monitor its credit exposure.

8.07 Additional risks, however, are involved in the overall credit process, and the institution should assess them when developing credit strategy, defining target markets, and designing proper controls over credit initiation and credit supervision. Those additional risks include the following:

- *Collateral Risk*. The institution may be exposed to loss on collateralized loans if its security interest is not perfected or the collateral is not otherwise under the institution's control, if the value of the collateral declines, or if environmental contingencies impair the value of the collateral or otherwise create liability for the institution.
- *Concentration Risk*. Inadequate diversification of the loan portfolio in terms of different industries, geographic regions, loan products, terms of loan products, or the number of borrowers may result in significant losses. A high concentration of loans to companies in a single industry would constitute a concentration risk. For example, membership of credit unions may be limited to employees of one organization or to individuals of a geographic region. If the credit union's sponsoring organization is experiencing financial problems or is anticipating layoffs of employees, the credit union could be exposed to significant losses. A high concentration of loans whose contractual features may increase the exposure of the originator to risk of nonpayment or realization would also constitute a concentration risk. For example, interest-only loans are designed to allow the borrower to only pay interest in the early part of the loan's term, which may delay defaults. For these loans, evidence of risk to loss may not become apparent until the contractual provisions of the loans cause a change in required payments.[†]
- *Country or Transfer Risk*. The economic, social, legal, and political conditions of a foreign country may unfavorably affect a borrower's ability to repay in the currency of the loan. Cross-border loans are those that borrowers must repay in a currency other than their

[†] Effective December 6, 2006, the Federal Reserve and other federal banking regulatory agencies issued Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices. The agencies have noted that commercial real estate lending has increased over the past few years. The agencies are concerned that many small-to-medium-sized institutions have not implemented risk management and capital levels that facilitate a sound CRE lending program. The guidance encourages ongoing risk assessments, and analysis of CRE lending policies. This includes evaluating the appropriateness of an institution's risk practices, as well as capital levels in relation to the size and complexity of its CRE portfolio. The guidance is applicable for state member banks, bank holding companies, as well as their non-bank subsidiaries.

local currency or to a lender in a different country. Losses may result if a country's foreign exchange reserves are insufficient to permit the timely repayment of cross-border loans by borrowers domiciled in that country, even if the borrowers possess sufficient local currency. In addition, foreign government decisions and associated events can affect business activities in a country as well as a borrower's ability to repay its loans.

- *Foreign Exchange Risk*. Changes in foreign exchange rates may affect lenders unfavorably. Fluctuations in foreign exchange rates could reduce the translated value of the cash flows, earnings, and equity investments in foreign currency denominated subsidiaries. Foreign exchange rate movements, if not effectively hedged, could also increase the funding costs of foreign operations as it is not uncommon for foreign operations to be funded by borrowings in currencies different than their functional currency.
- *Fraud Risk*. Loans may expose the institution to loss by not being bona fide transactions.
- *Insider Risk*. Loans to executive officers, directors, and principal shareholders of the institution and related interests of such insiders may expose the institution to loss if these loans are made to related individuals or companies, or both, with little credit history; if they lack an identified source of funds for repayment; or if they are made to newly organized or highly leveraged enterprises with insufficient collateral and inadequate financial information.
- *Interest-Rate Risk*. The maturity and repricing characteristics of loans can have a significant impact on the interest-rate risk profile (and, therefore, interest income) of an institution. For example, an institution that holds primarily fixed-rate loans could be adversely affected by a significant increase in interest rates.
- *Legal and Regulatory Risk*. Illegally granted loans, loans with usurious interest rates, and loans with terms that are not adequately disclosed to the borrower may expose the institution to loss.
- *Management Risk*. Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans could substantially affect the collectibility of loans.
- *Operations Risk*. Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure of the institution to evaluate and monitor potentially uncollectible loans also constitutes an operations risk.

Lending Policies and Procedures

8.08 Definitive lending policies and comprehensive procedures for implementing such policies can contribute significantly to the institution's internal control over financial reporting as it relates to the lending process.

8.09 The lending function can be broadly divided into the categories of (*a*) credit origination and disbursement, (*b*) credit supervision, (*c*) collection, and (*d*) loan review.

8.10 ***Credit Origination and Disbursement.*** Credit origination involves all the processes from the original request for credit to the disbursement of funds to the customer. Specific control features to meet operational—rather than financial reporting—objectives for credit origination usually include the following:

- Credit initiation, that is, obtaining complete and informative loan applications, including financial statements and the intended use of proceeds
- Credit investigation, including:
  - — Credit reports or other independent investigations
  - — Proper analysis of customer credit information, including the determination of projected sources of loan servicing and repayment
- Loan approval (new and renewed loans)
  - — Loan approval limits according to officer expertise, administrative authority, or both
  - — Committee approval or board of director approval, or both, for loans exceeding prescribed limits
  - — The segregation of duties between the loan approval function and the disbursement and collection functions
  - — Collateral ownership and control verified, including lien searches and documentation of the priority of security interest
  - — Collateral margin determined
- Documentation of credit, or the inspection of supporting documents for proper form, completeness, and accuracy by someone other than the lending officer
- Perfection of collateral interest or proper security filings and recording of liens
- The disbursement of loan proceeds or, to the extent possible, control of the disbursement to ensure that proceeds are used for the borrower's stated loan purpose

8.11 ***Credit Supervision.*** Loan officers are responsible for closely monitoring the loans in their portfolios and bringing problem loans to the attention of management. Their duties normally include obtaining and analyzing the borrower's periodic financial statements and credit histories, reassessing collateral values, making periodic visits to the customer's place of operation, and generally keeping abreast of industry trends and developments and of the customer's financial requirements and ability to perform. Management reports concerning loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. Input from loan officers is also important for identifying when loans should be reserved for or charged off.

8.12 ***Collection.*** Loans identified as problems under the institution's established criteria should be monitored, restructured, or liquidated, as appropriate. The institution normally attempts to work with the customer to remedy a delinquency. Traditional mortgage collection procedures are not as effective in high loan-to-value (LTV) products. Delinquent borrowers who have little or no equity in the property may not have the incentive to work with the lender; therefore, high LTV lenders must intervene early to reduce the risk of default and loss. Sometimes the debt is restructured to include terms the customer can satisfy; at other times, the institution obtains additional collateral to support the loan. However, when the loan is delinquent for a specified period of time, as normally defined in the institution's lending policy, the institution may begin legal proceedings such as foreclosure or repossession to recover any outstanding interest and principal.

8.13 ***Loan Review.*** Periodic review by institution personnel of the credit process and of individual loans is essential in assessing the quality of the loan portfolio and the lending process. Loan review preferably should be conducted by personnel who are independent of the credit origination, disbursement, supervision, and collection functions. Depending on the complexity of the organizational structure, these personnel report directly to the board of directors or to senior management. Loan review may be performed by specifically assigned staff or may be incorporated within an internal audit function.

8.14 Loan review includes several distinct activities. The principal emphasis is on determining whether the loans adhere to the institution's written lending policies and is likely to perform in accordance with the agreed-on terms and conditions, including compliance with any restrictive covenants in a loan agreement. The review normally includes analyzing the borrower's financial statements, reviewing performance since origination or last renewal, and determining if sufficient credit information is available to assess the borrower's current financial conditions.

8.15 Loan file contents should be reviewed as part of the institution's internal loan review process to determine if credit reports, appraisals, and other third-party information existed before the credit or renewal was granted and if the quality of such information supported, and continues to support, the credit decision. If the loan is secured or guaranteed, the review should also determine that collateral is under control, security interest is perfected, and guarantees have been executed properly. Also, the value of collateral should be estimated at the review date to identify deficiencies in collateral margins.

8.16 Loan review may identify weaknesses in the lending process or in the lending officers' skill in originating, supervising, and collecting loans. Loan review results should be documented and may be summarized in the form of subjective ratings of individual loans that are similar to regulatory examination classifications. In addition, loan review may reveal the need for a loss accrual, as discussed in Chapter 9, "Credit Losses."

Types of Lending

8.17 Lending institutions offer a variety of loan products to meet borrowers' needs and as part of their overall credit strategy and asset/liability management strategy. Loans may be made on a line-of-credit, installment, demand, time, or term basis. A brief description of each of those kinds of arrangements follows.

a. *Line-of-Credit Arrangements*. The institution provides the borrower with a maximum borrowing limit for a specified period. Lines of credit may be structured in a variety of ways. Letters of credit (discussed in paragraph 8.50 of this chapter), which are commonly used as credit enhancements for other forms of borrowing (such as commercial paper or trade financing), are agreements to lend a specified amount for a specified period (usually less than one year). Revolving credit agreements, which are commonly used in credit-card lending, are agreements to lend up to a specified maximum amount for a specified period, usually more than one year, and provide that repayment of amounts previously borrowed under the agreement are available to the borrower for subsequent borrowing. Repayment schedules may be on an installment, demand, time, or term basis, as discussed below. Other line-of-credit arrangements are applied to:

- *Construction*, whereby the borrower may draw on the line as necessary to finance building costs to supplement (or pending the securing of) a construction loan
- *Liquidity*, used by the borrower in overall management of its liquidity needs
- *Warehousing*, used by borrowers engaged in mortgage banking activities to fund origination of mortgage loans, generally pending sale of the loans to a secondary market investor

b. *Installment Loans*. These require periodic principal and interest payments. Installment loans may be made on either a simple interest or a discounted basis. The discounted basis means that interest (discount), credit-life insurance premiums, and other charges are generally added to the amount advanced to arrive at the face amount of the note. The discount, called *unearned interest*, is netted against the face amount of the note on the balance sheet and accreted into income over time to achieve a level yield.

c. *Demand Loans*. These have no fixed maturity date, are payable on demand of the lender, and generally have interest rates that change periodically. Demand loans generally require periodic interest payments.

d. *Time Loans*. These are made for a specific period of time. Interest is payable periodically, and principal is due at maturity. Such loans are often renewed at maturity in what is known as a "rollover." Interest rates, if fixed during the loan period, reprice when the loan is rolled over.

e. *Term Loans*. These are made for a specified term, generally in excess of one year, at a rate of interest that either is fixed or floats based on an independent index, such as the London Interbank Offered Rate (LIBOR), or prime or treasury rates. Repayment schedules are structured in a variety of ways. Some term loans are amortized on a regular installment schedule; others contain provisions for a large portion of the loan to be paid at maturity (a *balloon payment*); and still others may call for installments of irregular size and timing based on cash-flow projections.

8.18 Loans may be categorized in a variety of ways, depending on the institution. Institutions group loans in ways that are meaningful in their particular circumstances; for most, the groupings are based on the kind of borrower and the purpose of the loan. Some common categories of loans include (*a*) commercial, industrial, and agricultural; (*b*) consumer; (*c*) residential real estate; (*d*) lease financing; (*e*) trade financing; (*f*) commercial real estate and construction; and *(g)* foreign.

Commercial, Industrial, and Agricultural Loans

8.19 Despite changes in corporate borrowing practices (and increased competition from other kinds of financial institutions), commercial, industrial, and agricultural loans (sometimes called *C and I* or *business loans*) are an important part of many institutions' business. There are a wide variety of commercial, industrial, and agricultural loans. They include:

- Factoring the purchase, usually without recourse, of trade accounts receivable
- Revolving loans or short-term working capital loans, which are generally used by manufacturing companies to finance the purchase of raw materials and other production needs until the finished goods are sold
- Asset-based financing, usually secured by current assets such as accounts receivable or inventories, including receivable portfolio purchases
- Seasonal loans, which are used to provide cash to businesses (such as farms and retailers) during low-revenue periods of the year
- Floor-plan financing, which is used by automobile and durable goods dealers to finance inventories
- Long-term working capital loans
- Loans and leases to finance the purchase of equipment
- Loans to finance major projects, such as the construction of refineries, pipelines, and mining facilities

8.20 Large commercial loans may involve more than one lender (see the discussion of loan participations that follows). Commercial loans may be secured (that is, the institution holds a lien against pledged assets, such as securities, inventories, property and equipment, or accounts receivable) or unsecured. Also, such loans may be guaranteed or endorsed by third parties, including agencies of the U.S. government such as the Small Business Administration (SBA). Compensating-balance arrangements and commitment fees are often associated with commercial, industrial, and agricultural lending and are important factors in determining the interest rates on such loans. Commercial loans include demand loans, term loans, and line-of-credit arrangements.

8.21 ***Factoring.*** Factoring is the purchase, usually without recourse, of trade accounts receivable. A company that purchases trade accounts receivable is commonly called a *factor*. Factors buy trade accounts receivable from clients. Clients' customers send their payments directly to factors, often by means of a lockbox arrangement. Factored accounts receivable are not collateral for loans to clients; rather, the receivables are purchased outright. Except in certain instances involving advance factoring, as described below, no loan is made. However, clients continue to remain contractually responsible for customer claims related to defective merchandise.

8.22 Factors buy clients' invoices, net of trade and cash discounts granted to customers, and provide clients with services that include assuming the clients' responsibilities of credit review, bookkeeping, and collection. Factors also assume risks of credit losses when customer credit is approved before clients ship goods. Usually, if factors do not approve customers' credit, shipments are made at clients' risk. Factors buying accounts with recourse, however, provide bookkeeping and collection services and assume no credit risk, unless both the client and its customers become insolvent. Factors receive fees for services rendered to the client, usually computed as a percentage of net receivables bought.

8.23 Factoring usually requires that customer notification be placed on the face of invoices, indicating that accounts have been sold and that factors are to be paid directly. Under nonnotification contracts, customers continue to pay clients and normally are unaware of factor ownership of the related accounts.

8.24 Two types of factoring arrangements are maturity and advance. Maturity factoring requires factors to pay clients only when related accounts are due (generally based on average due dates) or collected. In contrast, advance factoring allows clients to draw cash advances against the balance of the receivables before they are due or collected. Factors charge interest from the date on which advances are drawn to the date on which receivables are due or collected, at rates usually based on a stipulated percentage over commercial banks' prime rates.

8.25 In calculating limits for payments under advance factoring arrangements, factors generally retain a reserve against unpaid receivables to cover claims, returns, allowances, and other adjustments. Reserves ordinarily are a percentage of outstanding receivables based on factors' experience and judgment. Overadvances occur when clients draw cash advances that exceed uncollected receivable balances. Factors may permit overadvances to finance clients' seasonal business requirements. Such overadvances often can be anticipated. Overadvances also may result from unanticipated chargebacks, such as those resulting from defective merchandise and price disputes, because clients continue to remain contractually responsible for such problems. Overadvances may be collateralized by other assets, such as inventory or fixed assets, or may be secured by personal guarantees. In certain circumstances, overadvances also may be unsecured. Overadvances generally are reduced when receivables from additional sales are factored.

8.26 ***Revolving Loans.*** Revolving loans, sometimes called working capital loans, generally provide borrowers with the cash needed for business operations. The loans usually are collateralized by accounts receivable and generally cannot exceed agreed percentages of the face values of those receivables. Such loans may be referred to as *accounts receivable loans*. Collections against such receivables usually are remitted daily by borrowers to the lenders. Depending on the terms of the agreements, new accounts receivable acquired by borrowers and pledged to lenders may immediately qualify as collateral.

8.27 Lenders' policies may permit eligible collateral for revolving loans to be expanded to include inventories if borrowers require additional cash. In such cases, additional advances may be referred to as inventory loans. Inventory loans supplementing accounts receivable loans are common when seasonal businesses generate relatively low amounts of accounts receivable but require large inventories in anticipation of the selling season. When the inventories are sold, loans are paid off or accounts receivable generated by the sales replace inventories as collateral for such loans.

8.28 ***Receivables Portfolio Purchase Agreements.*** Unlike factoring arrangements, receivables portfolio purchases are bulk purchases of trade accounts or finance receivables, often intended to provide sellers with cash for operations or improved financial ratios. Because the buyers usually assume all credit risks, a stipulated percentage of the purchase price is often retained to absorb credit losses. Credit losses in excess of that amount are borne by the buyer.

8.29 Terms of portfolio purchase agreements vary. Some provide for single purchases; others provide for continuing purchases on a revolving basis. In addition, customers may not be notified of purchases or may be notified and required to pay the buyer directly. Receivables acquired under this type of agreement generally are accounted for as assets owned by the buyer and are not considered to represent collateral for loans made to sellers.

8.30 ***Floor Plan Loans.*** Floor plan loans, commonly called wholesale loans, are made to businesses to finance inventory purchases. Some lenders make floor plan loans primarily to induce dealers to allow the lenders to buy the retail contracts generated from sales of inventories. Inventories serve as collateral for floor plan loans, the amounts of which usually are limited to the wholesale values of the inventories. Unlike revolving loans collateralized by inventory, floor plan loans generally are collateralized by specific inventory items. They also require minimum payments known as *curtailments*, with balances becoming due when collateral is sold or at the end of stipulated periods.

Consumer Loans

8.31 Consumer loans are loans to individuals for household, family, and other personal expenditures. Commonly, such loans are made to finance purchases of consumer goods, such as automobiles, boats, household goods, vacations, and education. Interest rates and terms vary considerably depending on many factors, including whether the loan is secured or unsecured. The two most significant kinds of consumer lending are installment loans and revolving credit arrangements (credit-card lending).

8.32 ***Installment Loans.*** Consumer installment loans, which are generally secured by the item purchased, may be acquired directly from an institution's customers (direct paper) or indirectly from a dealer's customers (indirect paper or retail sales contracts).

8.33 ***Retail Sales Contracts.*** Many sales of consumer goods and services are financed through retail sales contracts. Those contracts are made, directly or through retailers and dealers, with individual consumers. The contracts often are sold to a lender. Retail sales contracts commonly are called three-party paper because they involve three parties, namely, an individual borrower, a dealer or distributor, and a lender.

8.34 Retail sales contracts usually are sold at a discount to a lender under terms that permit dealers or distributors to share a portion of the finance charges paid by borrowers. Provisions for dealers' shares of finance charges vary among lenders and dealers. Dealers' shares of finance charges may be based on stipulated percentages of the finance charges or the principal amounts of the retail contracts, on a fixed amount for each contract, or on other negotiated terms. The Office of the Comptroller of Currency frequently issues guidance on retail sales contracts.

8.35 Some agreements provide for a portion of the amounts due to dealers to be withheld to cover certain contingencies. Other agreements provide no such conditions. Amounts withheld from dealers may either be limited to or greater than the dealers' shares of finance charges. Dealer reserves represent liabilities for unpaid portions of dealers' shares of finance charges on retail contracts bought from dealers. Dealer holdbacks, which are not limited to dealers' shares of finance charges, also represent liabilities, but usually are for amounts withheld from dealers on retail contracts with greater-than-normal credit risk. Such risks may relate to factors such as the types of collateral, excessive loan periods, or the credit ratings of the borrowers involved. Dealer reserves and holdbacks may be required even if applicable contracts are bought with recourse.

8.36 ***Credit Cards.*** Credit-card lending is a major business for many institutions. Institutions may participate in the credit-card market in various ways. Some institutions may issue or make credit cards available directly to customers. Institutions may also sponsor cards that are issued by another institution. The sponsoring institution may take credit applications, perform credit checks, and have its name printed on the cards, but the issuing institution records the consumer loans and assumes the credit risk. Most credit-card lending is on an unsecured basis, although some secured programs exist. Within geographic areas, there are service companies that centralize card issuance, process transactions, and maintain customer accounts.

8.37 Credit-card holders receive prenumbered cards under a prearranged line of credit with the institution issuing the card. Though the terms of credit cards vary, an annual fee is often charged for the use of the card and interest is charged on outstanding balances. Cards typically carry a twenty- to thirty-day grace period during which no interest is charged if outstanding balances are paid in full. Furthermore, merchants are generally charged a transaction fee.

8.38 Many institutions that issue credit cards have agreements with one of the two major international bank card systems, Visa and Interbank (MasterCard). However, a number of financial institutions have independent plans. The main functions that the bank card systems perform are enrolling merchant members and providing authorization and clearing systems. The main functions that the issuing institutions perform are issuing cards, setting credit limits, billing, collections, and customer service.

8.39 ***Overdraft Protection.*** Another type of revolving credit is overdraft protection on checking accounts. Overdraft protection is an agreement between an institution and its customer to provide a prearranged line of credit that is automatically drawn if the customer writes checks greater than the amount in his or her deposit account. Interest is charged on amounts outstanding.

Residential Real Estate Loans

8.40 Loans secured by one- to four-family residential property of the borrower are generally referred to as *residential mortgage loans*. Repayment terms for residential mortgage loans may vary considerably. Such loans may be structured to provide for the full amortization of principal, partial amortization with a balloon payment at a specified date, or negative amortization. Interest rates may be fixed or variable. Variable-rate loans generally are referred to as adjustable-rate mortgages (ARMs). In addition, institutions may require borrowers in certain circumstances to purchase private mortgage insurance to reduce the institution's credit risk.

8.41 Many different types of first and second lien residential mortgage loans have become popular, including:

- Reverse mortgages, which provide homeowners with monthly payments in return for decreasing equity, wherein the institution may eventually gain ownership of real estate

- Second-lien fixed-term (or closed end) loans through which homeowners borrow a portion of their equity (property value in excess of the first-lien balance) and repay such over a fixed period of time with fixed or variable interest rates

- Home equity lines of credit allow the homeowner to borrow on demand, a portion of their equity, repay such and reborrow, if desired

- 125 loans allow the homeowner to borrow amounts in excess of their equity, for example, up to 125 percent of the property value

- Adjustable Rate Mortgage (ARM), Negatively Amortizing Mortgage (NegAm), and Option Adjustable Rate Mortgage (Option ARM) are non traditional type loans. Their interest rate and payment may change over time and these loans may require specialize underwriting and monitoring.

8.42 The Federal Housing Administration (FHA) insures and the Department of Veterans' Affairs (VA) partially guarantees many residential real estate mortgages. The FHA sets minimum down payments and interest rates for FHA loans. FHA-insured borrowers pay an annual insurance premium computed each year on the loan balance at the beginning of the year. The VA guarantee program, which was initiated to enable veterans to obtain homes when they return from military service, provides certain features, including an interest-rate ceiling that is generally lower than prevailing market rates, a partial guarantee to the lender, a low (or no) down payment, and a prohibition against mortgage brokers' commissions. Residential mortgage loans that are not FHA-insured or VA-guaranteed are called *conventional loans*.

8.43 Chapter 10 includes further discussion of residential real estate loans.

Lease Financing

8.44 Institutions also may be involved in direct lease financing, in which an institution owns and leases personal property for the use of its customers at the customers' specific request. A typical lease agreement contains an option providing for the purchase of the leased property, at its fair value or at a specified price, by the lessee at the expiration of the lease. Such leases may be financing transactions (discussed in paragraph 8.102 of this chapter). Despite similarities between leases and other forms of installment loans, continuing legal and tax changes have resulted in language and procedures unique to leasing activities.

8.45 ***Operating Leases.*** An operating lease is a rental agreement in which asset ownership resides with the lessor. At the end of the lease term, the lessee may renew the lease, purchase the equipment, or return it to the lessor. During the course of the lease, the lessee expenses the rental payment made. As these types of agreements are in substance usage agreements, the debt is allowed to remain off the lessee's balance sheet. The lessor records the equipment as an asset and is required to depreciate it. Operating leases generally run for periods considerably shorter than the useful lives of related assets. At the expiration of such leases, the assets generally are sold or leased again.

8.46 Direct financing leases are similar to other forms of installment lending in that lessors generally do not retain benefits and risks incidental to ownership of the property subject to leases. Such arrangements are essentially financing transactions that permit lessees to acquire and use property.

8.47 ***Leveraged Leasing.*** Leveraged leasing involves at least three parties, namely, a lessee, a long-term creditor, and a lessor (commonly called the *equity participant*). The lessor may, however, be represented by an owner trustee. Finance companies and other lenders frequently enter into leveraged lease transactions as lessors or equity participants. A substantial portion of the purchase price of assets is supplied nonrecourse by unaffiliated long-term lenders. If a lessee defaults on lease payments, the long-term lender has no recourse to the lessor, but usually has recourse to the specific property being leased. The gross return to a finance company or lender is measured using the discounted net cash receipts generated from investment tax credits and the tax effects of timing differences resulting principally from the use of accelerated depreciation in tax returns, rental payments minus debt service costs, and the estimated residual values of equipment leased.

8.48 Leasing arrangements also may be categorized as transactional, involving direct negotiations between a lessor and lessee, and as vendor leasing. Transactional lease financing tends to be a time-consuming and expensive process that is economically feasible only for transactions sufficiently large to generate profits in excess of the costs of preparing custom-made leases. Vendor leasing has developed to finance asset acquisitions that would not be profitable to finance with transactional leasing arrangements. Vendor leasing involves a third-party lessor that offers a vendor's or manufacturer's customers a basic finance package. The lessor usually establishes interest rates within given dollar ranges and uses a standardized credit scoring process to approve credit and keep documentation simple. As a result, vendors are promptly paid for sales and avoid the need to perform in-house financing operations. Some lenders also may serve as *lease brokers*—that is, as intermediaries between lessors and lessees for a fee.

Trade Financing

8.49 *Tradefinancing* is a specialized area of commercial lending frequently used by businesses that engage in international activities. Such financing includes open account financing, sales on consignment, documentary collections, advances against collections, letters of credit, bankers' acceptances, factoring, and forfeiting. Lending institutions charge fees for such arrangements. The most commonly used of these arrangements is the letter of credit.

8.50 The two primary types of letters of credit are the commercial letter of credit and the standby letter of credit. A *commercial letter of credit* represents a commitment by the issuing institution to make payment for a specified buyer to a specified seller in accordance with terms stated in the letter of credit. Under a *standby letter of credit*, the issuing institution guarantees that the buyer will make payment. The issuing institution is not ordinarily expected to make payment; however, if it does make payment, the buyer is obligated under the agreement to repay the institution. Standby letters of credit are also used to guarantee the performance of U.S. companies under contracts with foreign corporations and foreign or domestic governments. Depending on the nature of the agreement, these transactions may involve a high degree of credit risk.

Commercial Real Estate and Construction Loans‡

8.51 Loans made on real property such as office buildings, apartment buildings, shopping centers, industrial property, and hotels are generally referred to as *commercial real estate loans*. Such loans are usually secured by mortgages or other liens on the related real property. Repayment terms on commercial real estate loans vary considerably. Interest rates may be fixed or variable, and the loans may be structured for full, partial, or no amortization of principal (that is, periodic interest payments are required and the principal is to be paid in full at the loan maturity date). Some give the institution recourse to third parties, who guarantee repayment of all or a portion of the loans. Others are nonrecourse, that is, if the borrower cannot repay the loan, the lender has only the collateral as a source of repayment—the lender does not have recourse to any other source of repayment.

8.52 *Construction lending* involves advances of money from a bank or savings institution to finance the construction of buildings or the development of raw land. The institution generally agrees to a specified loan amount, part of which will be disbursed to the borrower at the inception of the project and part of which will be disbursed as construction progresses, based on specified milestones that were agreed to by the institution and the borrower. Construction loans are generally made for the construction period only, which generally runs from one to seven years. Often, both interest and principal are payable at maturity. After construction is completed, the borrower usually obtains long-term mortgage financing from another financial institution. Large commercial real estate and construction loans may involve more than one lender (discussed in paragraph 8.55 of this chapter).

8.53 Certain real estate loan arrangements, in which the lender has virtually the same risks and potential rewards as those of the owners of the property, should be considered and accounted for as investments in real estate. Certain real estate acquisition, development, and construction (ADC) arrangements that should be accounted for as investments in real estate are discussed in Chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets."

Foreign Loans

8.54 Foreign (or cross-border) loans are made primarily by larger institutions and consist of loans to foreign governments, loans to foreign banks and other financial institutions, and commercial and industrial loans. Foreign loans also include consumer and commercial lending, including real estate loans, made by foreign branches. Such loans may contain certain risks, not associated with domestic lending, such as foreign exchange and country or transfer risks, as described previously in paragraph 8.07. This type of lending exposes the institution to cross-border risk, which is the possibility that the borrowing country's exchange reserves are insufficient to support its repayment obligations.

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‡ The federal banking regulators have issued a proposal, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices. For additional information see the Federal Register: January 13, 2006 (Volume 71, Number 9).

Loans Involving More Than One Lender

8.55 Institutions sometimes receive requests for loans that exceed the institution's capacity or willingness to lend. In response, shared lending arrangements have been created. In a *syndication lending arrangement*, groups of institutions agree to participate in a particular loan, with each institution being a direct creditor of the borrower but with uniform lending terms applied by all the institutions. One institution is typically appointed as the agent, or lead institution, having primary responsibility for communication and negotiation with the borrower. The lead institution may also service all loans in the group. In a *participation lending arrangement*, a lead institution originates a loan for the entire amount and sells to other lenders (participating institutions) portions of the loan it originated. The lead institution disburses all funds, supervises the perfection of legal interests in the underlying collateral, and usually services the loan. Loan participations may be negotiated on either a recourse or nonrecourse basis. Also, a participation may be sold on terms that differ from the original loan terms.

8.56 In a loan syndication, the participating institutions arrange a lending syndicate in which the lead syndicator and participants in the syndication fund their respective portions of the loan. A syndication typically involves less risk to a lead institution than a participation because the lead institution funds only its portion—rather than the entire amount—of the loan at origination. A major difference between syndications and participations relates to the accounting by the agent/lead institution. Readers should refer to Emerging Issues Task Force (EITF) Issue No. 97-3, *Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125*, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities for additional guidance. (The replacement of FASB Statement No. 125 by the issuance of FASB Statement No. 140 does not affect the consensuses on this EITF.)

Regulatory Matters

Real Estate Lending Standards

8.57 The federal banking agencies have established real estate lending standards and related guidelines that describe the factors management should address in its real estate lending policies.[1] Each institution is required to adopt and maintain written policies that establish limits and standards for extensions of credit related to real estate. The lending policies must establish:

a. Portfolio diversification standards

b. Underwriting standards, including LTV ratio limitations

c. Loan administration policies

d. Documentation, approval, and reporting requirements to monitor compliance and appropriateness

8.58 Management's policies are to be appropriate to the size of the institution and the nature and scope of its operation, and the board of directors of the institution is to review and approve the policies at least annually.

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[1] See Title 12 of the Code of Federal Regulations (12 CFR), Parts 34 (OCC); 208 (FRB); 365 (FDIC); and 560 (OTS).

8.59 In supplementary guidelines, the agencies outline considerations for loan portfolio management, underwriting standards, loan administration, LTV ratios, and policy exceptions. See Office of the Comptroller of the Currency (OCC) Banking Bulletin 92-75.

8.60 On October 8, 1999, the federal banking agencies jointly issued the Interagency Guidelines on High LTV Residential Real Estate Lending, which highlight the risks inherent in this activity and provides for supervisory limits and capital considerations. The guidelines set forth the supervisory expectation that high LTV portfolios, as defined, will not exceed 100 percent of total capital. Institutions that approach this limit will be subject to increased supervisory scrutiny. If the limit is exceeded, then its regulatory agency will determine if the activity represents a supervisory concern and take action accordingly. Policy and procedure guidelines provided in the 1992 Interagency Guidelines for Real Estate Lending Policies apply to these transactions.

8.61 *Appraisals*. The federal banking agencies require an appraisal by a certified or licensed appraiser for real estate-related financial transactions (as defined) having a value of $250,000 or greater. The appraisal rules exempt certain transactions.[2] The National Credit Union Act (NCUA) requires an appraisal by a certified or licensed appraiser for real estate-related transactions having a value of $250,000 or more, or for special circumstance transactions as defined in Part 722 Appraisals paragraph 722.3 of the NCUA Rules and Regulations.

Retail Credit Loans and Residential Mortgage Loans

8.62 On June 6, 2000, the federal banking agencies issued the Uniform Retail Credit Classification and Account Management Policy, which instructs institutions on the review and classification of retail credit loans and residential mortgage loans. Institutions should adopt the standards contained in the policy as part of their loan review program. The guidelines include requirements for the classification and charge-off of retail credit and mortgage loans, as well as fraudulent loans and bankruptcy cases. See Federal Reserve Board (FRB) Supervisory and Regulatory Letter (SR) 00-8.

Credit Card Lending

8.63 On January 8, 2003, the OCC, FRB, FDIC and OTS issued *Account Management and Loss Allowance Guidance for Credit Card Lending*. The issuance communicated the expectations for prudent practices in a variety of account management, risk management, and loss allowance practices of institutions engaged in credit card lending. The account management portion of the guidance covers credit lines, overlimit practices, negative amortization, workout programs, and settlements. The loss allowance portion of the guidance covers a number of factors that should be considered by institutions when they estimate and account for their allowance for loan losses. For further information, on credit losses, see Chapter 9.

Nontraditional Mortgage Products

8.64 Because of increased consumer demand for closed-end residential mortgage loan products that allow borrowers to defer repayments of principal and sometimes interest, mortgage institutions are offering nontraditional

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[2] See Title 12 CFR Parts 34 (OCC); 225 (FRB); 323 (FDIC); and 564 (OTS).

mortgage loans such as "interest only" mortgages, or mortgages with subprime interest rates. On September 29, 2006, the federal banking agencies issued the Interagency Guidelines on Nontraditional Mortgage Product Risks including the use of subprime loans. The guidelines remind banks of the risks inherent in nontraditional mortgage lending and outline the types of risks and controls that are expected for an institution that enters this field of lending. Institutions should establish an appropriate allowance for loan and lease losses (ALLL) for estimated credit losses inherent in their nontraditional mortgage loan portfolios. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Institutions should also use "stress tests" to analyze the performance of their nontraditional mortgage portfolios.

Income Recognition on Problem Loans

8.65 Following issuance of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, the federal banking agencies announced they would retain their existing nonaccrual policies governing the recognition of interest income.[3]

8.66 NCUA guidelines state that loans delinquent for three months or more should be placed on nonaccrual status and that accrual of interest on loans should be reversed when the loan is determined to be a loss or when it becomes twelve months delinquent, whichever occurs first. State credit union regulators may also have specific requirements for the discontinuance and reversal of accrued income.

Credit Union Lending Restrictions

8.67 Credit unions can generally only make loans to members. Further restrictions include, but are not limited to, loan to value limits, limits on loans to one borrower, limits on member business loans (NCUA Regulation 701.21(h)), and limits on loans to officers, directors, and employees.

Lending Statutes

8.68 Certain of the more significant federal and state statutes related to consumer and mortgage lending activities follow:

- *Home Mortgage Disclosure Act (HMDA).* The HMDA requires that mortgage lenders compile and report to the institution's regulatory agency, certain information applicable to applications for home acquisition and improvement loans. The objectives of the regulation are to provide information to the public regarding whether the institution is serving the credit needs of the neighborhoods it serves, and to assist public officials in targeting private-sector investments to the areas in which they are most needed.
- *Fair Lending Statutes.* These statutes include the Equal Credit Opportunity Act and the Fair Housing Act, which prohibit discrimination in lending and housing-related activities, and the Fair Credit Reporting Act, which regulates consumer credit reporting activities.

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[3] The announcement was published in the *Federal Register* on February 10, 1995.

- *Real Estate Settlement Procedures Act (RESPA).* The RESPA is administered by the U.S. Department of Housing and Urban Development (HUD) and requires the disclosure to mortgage loan applicants of information about the costs and procedures involved in loan settlement.

- *Direct Consumer Lending.* State laws regulating consumer finance operations are designated as licensed-lending, small-loan, or consumer-financing statutes. Diverse state statutes usually regulate mortgage loans and other direct consumer loans. Usually, each branch office of a company that makes direct consumer loans must be licensed by the state in which the office is located. State licensing authorities, many of which are divisions of state banking departments, examine loans to ascertain that they comply with statutory provisions and to determine whether rebates and refunds are properly computed.

- *Retail Sales Financing.* Laws governing retail sales financing may require offices to be licensed or registered. The laws vary widely among states. For example, all goods statutes may govern consumer goods loans; other goods laws may govern loans for consumer goods excluding automobiles. Additional statutes may affect revolving credit arrangements.

- *Federal Consumer Credit Protection Act (Truth in Lending Act).* The act, through Federal Reserve Regulation Z, requires disclosure of finance charges and annual percentage rates so that consumers can more readily compare various credit terms. It does not set maximum or minimum rates of charges.

Uniform Commercial Code

8.69 The Uniform Commercial Code (UCC), fully adopted by all states, is a set of statutes designed to provide consistency among state laws concerning various commercial transactions. Article 9 of the UCC, which addresses secured transactions, contains especially significant laws that affect financing activities. It applies to two-party collateralized loan transactions as well as to sales of accounts receivable and retail sales contracts, which are essentially three-party transactions. Article 9 generally provides certain rights to the secured parties and the debtors involved in secured transactions. The definition of a secured party includes a lender who obtains a security interest as well as a buyer of trade accounts receivable or retail sales contracts. Similarly, the definition of a debtor includes both the individual obligor and the seller of trade accounts receivable or retail sales contracts.

8.70 Under Article 9, all transactions creating a security interest are treated alike. The Article sets forth various procedures necessary to safeguard, or *perfect*, the potential creditor's interest in collateral against the interests of other creditors. Those procedures generally require that the creditor file a *financing statement* at a specified public office. The statement, available for public inspection, provides legal notice of a perfected security interest. Consequently, before making collateralized loans, prospective lenders generally search the public files to determine if other lenders have already filed financing statements against the collateral.

8.71 For certain commercial financing activities, Article 9 permits *continuing general lien arrangements*, in which a security interest applies continuously to all present and future collateral of the type described in the financing statement for as long as the financing statement is effective. That provision simplifies, for example, maintaining security interests in purchased receivables and in collateral securing revolving loans. The underlying collateral becomes subject to the security interest as soon as it comes into existence or into the debtor's possession. The financing statement is generally effective for five years from the date of filing and then lapses, unless a *continuation statement* is filed within the six-month period before the expiration date. The continuation statement extends the security interest for another five years.

Accounting and Financial Reporting

8.72 Statement of Position (SOP) 01-6, *Accounting By Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others,* paragraph 8*(a)*, states that loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any chargeoffs, the allowance for loan losses (or the allowance for doubtful accounts), any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans. (Chapter 9 addresses the allowance for loan losses.) Loans, interest-only strips, other receivables, or retained interests in securitizations that can be prepaid or otherwise settled in such a way that the institution would not recover substantially all of its recorded investment shall be subsequently measured like debt securities classified as available for sale or trading under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.[4] Readers may refer to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, paragraph 14, for further guidance.[5]

8.73 In February of 2006, the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement.

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[4] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* The guidance in this FSP should be applied to reporting period beginning after December 15, 2005 . The In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Liabilities*, which amends FAS Statement No. 115.

[5] The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. The comment period has ended and readers are urged to monitor developments. In November of 2005 the FASB staff issued FASB Staff Position (FSP) 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*. This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

8.74 In March of 2006, the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

8.75 Mortgage loans held for sale should be reported at the lower of cost or market value in conformity with FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, paragraph 22(b) amends FASB Statement No. 65 to require that if a mortgage loan has been the hedged item in a fair value hedge, the loan's "cost" basis used in the lower-of-cost-or-market accounting shall reflect the adjustments of its carrying amount. After the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities should classify the resulting mortgage-backed securities (MBSs) or other retained interests based on its ability and intent to sell or hold those investments.

8.76 SOP 01-6, paragraph 8(*b*), states that nonmortgage loans held for sale should be reported at the lower of cost or fair value. Chapter 10 of this Audit and Accounting Guide (Guide) addresses accounting and reporting at the time the decision is made to sell loans. This chapter addresses accounting and reporting subsequent to a transfer into a held-for-sale classification.

8.77 On March 26, 2001, the Federal Financial Institutions Examination Council (FFIEC) issued Interagency Guidance on Certain Loans Held for Sale, to provide instruction to institutions and examiners about the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to an held for sale (HFS) account. That guidance also addresses subsequent declines in value for loans within its scope and states:

> After a loan or group of loans is transferred to the HFS account, those assets must be revalued at each subsequent reporting date until sold and reported at the lower of cost or fair value. Any declines in value (including those attributable to changes in credit quality) and recoveries of such declines in value occurring after the transfer to the HFS account should be accounted for as increases and decreases in a valuation allowance for HFS loans, not as adjustments to the ALLL. Changes in this valuation allowance should be reported in current earnings. The valuation allowance for HFS loans cannot be reduced below zero (that is cannot have a debit balance).

8.78 SOP 01-6, paragraph 8(*m*), states that transfers of receivables under factoring arrangements meeting the sale criteria of paragraph 9 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, are accounted for by the factor as purchases of receivables. The acquisition of receivables and accounting for purchase discounts such as "factoring commissions" should be recognized in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, as applicable. Transfers not meeting the sale criteria in FASB Statement

No. 140[6] are accounted for as secured loans (that is, loans collateralized by customer accounts or receivables). Paragraph 15 of FASB Statement No. 140 provides additional guidance in those situations. Factoring commissions under these arrangements should be recognized over the period of the loan contract in accordance with FASB Statement No. 91. That period begins when the finance company (or an entity with financing activities, including trade receivables) funds a customer's credit and ends when the customer's account is settled.

8.79 Transfers accounted for as sales are addressed in Chapter 7, "Investments in Debt and Equity Securities."

Interest Income

8.80 Interest income on loans should be accrued and credited to interest income as it is earned, using the interest method. Disclosures about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans are established in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended.

8.81 SOP 01-6, paragraph 12, states that transactions in which captive finance companies offer favorable financing to increase sales of related companies are not exempted from the scope of Accounting Principles Boards (APB) Opinion No. 21, *Interest on Receivables and Payables*, by paragraph 3(d) of that Opinion. APB Opinion No. 21 provides accounting guidance to use if the face amount of a note does not reasonably represent the present value of the consideration given or received in an exchange.

8.82 Delinquency fees are amounts debtors pay because of late payment on loans. Such fees are generally small and are intended to cover additional interest on precomputed loans, to compensate the lender for additional collection costs associated with delinquencies. SOP 01-6, paragraph 8(*j*), states that delinquency fees should be recognized in income when chargeable assuming collectibility is reasonably assured.

8.83 Prepayment penalties are amounts borrowers pay to lenders, in addition to remaining outstanding principal, if borrowers pay off loans prior to contractual maturities. SOP 01-6, paragraph 8(*k*), states that prepayment penalties should not be recognized in income until loans (or trade receivables, if applicable) are prepaid, except that the existence of prepayment penalties may affect the accounting resulting from the application of paragraph 18(a) of FASB Statement No. 91.

8.84 Rebates are cancellations of portions of the precomputed finance charges on discount loans that occur when loan payments are made ahead of schedule. Rebate calculations generally are governed by state laws and may differ from unamortized finance charges on discount loans because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method. Finance companies may charge various types of fees to customers in connection with lending transactions including prepayment penalties—amounts borrowers pay to lenders, in addition to remaining outstanding principal, if borrowers pay off loans prior to contractual maturity. SOP 01-6, paragraph 8(*l*), states that rebates represent refunds of portions of the precomputed finance charges on installment loans (or trade receivables, if applicable) that occur when payments are made ahead of schedule. Rebate

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[6] See footnote 5 in paragraph 8.72.

calculations generally are governed by state laws and may differ from unamortized finance charges on installment loans or trade receivables because many states require rebate calculations to be based on the Rule of 78s or other methods instead of the interest method. The accrual of interest on installment loans or trade receivables should not be affected by the possibility that rebates may be calculated on a method different from the interest method, except that the possibility of rebates affects the accounting resulting from the application of paragraph 18(a) of FASB Statement No. 91. Differences between rebate calculations and accrual of interest income merely adjust original estimates of interest income and should be recognized in income when loans or trade receivables are prepaid or renewed.

Loan Fees, Costs, Discounts, and Premiums

8.85 FASB Statement No. 91 establishes the accounting for loan origination fees and costs.[7] In general, loan origination fees net of direct loan origination costs should be deferred and recognized over the contractual life of the loan as an adjustment of yield using the interest method. Nevertheless, for certain homogeneous pools of loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the institution may consider estimates of prepayments in the calculation of the constant effective yield necessary to apply the interest method. Direct loan origination costs include only incremental direct costs incurred in transactions with independent third parties and certain costs directly related to specified activities performed by the lender. Deferred costs include only the direct costs of completed loans and must be deferred irrespective of the existence of related loan fees. Direct costs of unsuccessful loan origination efforts and all indirect costs are charged to expense as incurred.

8.86 FASB Statement No. 91[8] requires that fees received for a commitment to originate or purchase a loan or group of loans should be deferred except for certain retrospectively determined fees. If the commitment is exercised, the commitment fee should be recognized as an adjustment of yield over the related loan's life. If the commitment expires unexercised, the commitment fee should be recognized in income upon expiration of the commitment. However, commitment fees for which the likelihood of exercise is remote should be recognized over the loan commitment period on a straight-line basis.

8.87 FASB Statement No. 91 considers that for purchased loans, the initial investment includes the amount paid to the seller, net of fees paid or received. All other costs related to the purchase of loans are charged to expense as incurred. Premiums and discounts on purchased loans are recognized as an adjustment of yield over the contractual life of the loan. If the institution holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, paragraph 19 of FASB Statement No. 91 allows the institution to consider estimates of future principal prepayments in calculation of the constant effective yield necessary to apply the interest method.

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[7] The staff of the FASB has also published a FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*.

[8] FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amended FASB Statement No. 91, as it relates to certain loan commitments. FASB Statement No. 91 does not apply to fees and costs related to commitments to originate, sell, or purchase loans that are accounted for as derivatives under FASB Statement No. 133.

8.88 FASB Statement No. 91 also provides guidance on accounting for fees and costs related to loans with no scheduled payment terms (demand loans) and revolving lines of credit. The Statement stipulates that net deferred fees and costs on demand loans should be recognized on a straight-line basis over (*a*) a period consistent with the institution's understanding with the borrower or (*b*) if no understanding exists, an institution's estimate of the period over which the loan will remain outstanding. Fees and costs on revolving lines of credit should be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

8.89 Paragraph 12 of FASB Statement No. 91 requires that the accounting for net fees or costs related to refinancings or restructurings (other than troubled debt restructurings) be based on whether the terms of the new loan are at least as favorable to the lender (based on effective yield) as the terms of comparable loans. FASB Statement No. 91 also discusses a variety of other amortization issues, including the treatment of increasing, decreasing, and variable-rate loans.

8.90 Discussion by the FASB's Emerging Issues Task Force (EITF) of Issues No. 88-20, *Difference Between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio*, No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*, No. 93-1, *Accounting for Individual Credit Card Acquisitions*, No. 97-3, *Accounting for Fees and Costs Associated With Loan Syndications and Loan Participations After the Issuance of FASB Statement 125*, and No. 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*, provide related guidance.

Amortization of Discounts on Certain Acquired Loans

8.91 AcSEC issued AICPA Practice Bulletin No. 6 in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined).[9] For acquired loans or other debt securities within its scope, Practice Bulletin No. 6 includes guidance on (*a*) amortization of discounts that reflect impairment due to credit risk, (*b*) initial and subsequent recognition of principal and interest, and (*c*) assessing collectibility. Practice Bulletin No. 6's provisions on these issues are inconsistent with certain provisions of FASB Statements No. 114, as amended by FASB Statement No. 118 (and related amendments of FASB Statements No. 5, *Accounting for Contingencies*, and No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*) and FASB Statement No. 115. FASB Statements No. 114, No. 115, and No. 118 take precedence for loans and debt securities within their scope. SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, governs accounting for *problem* loans, that is, the loans must have evidence of credit quality deterioration and the purchaser must not expect to collect contractual cash flows.[||] For problem loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin No. 6, paragraphs 7 and 8 of SOP 03-3, as they apply to decreases in cash

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[9] Related financial reporting by liquidating banks is beyond the scope of Practice Bulletin No. 6 and was addressed in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank*.

[||] The AICPA has recently issued a Technical Practice Aid, *Application of SOP 03-3*, Accounting for Certain Loans or Debt Securities Acquired in a Transfer to Debt Securities. For additional information visit the AICPA Web site.

flows expected to be collected, should be applied prospectively for fiscal years beginning after December 15, 2004.

8.92 SOP 03-3 applies to problem loans acquired individually, in a portfolio, or in acquisition. The SOP does not apply to any entity originated loans, or acquired loans without evidence of credit quality deterioration.[10] SOP 03-3 should be applied to loans individually to meet the scope criteria and individual loans are not to be aggregated for determining whether they, as a group, are within the scope. Because the use of aggregation may result in different scope applicability, aggregation is only allowed for recognition, measurement and disclosure purposes.

8.93 SOP 03-3 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment (purchase price) in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. Paragraph 5 of SOP 03-3 states that cash flows expected in excess of the initial investment should be recognized as yield. Yield that may be accreted (accretable yield) is limited to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan. SOP 03-3 also requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable differences) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. The SOP prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment.

8.94 Paragraph 4 of SOP 03-3 prohibits "carrying over" or creating valuation allowances in the initial accounting of all loans acquired in a transfer that are within the SOP's scope. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination. Finally, new disclosures are required, in addition to those already required by other accounting literature, including FASB Statements No. 5, *Accounting for Contingencies*; No. 114; No. 115; and No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*. See the SOP for additional guidance pertaining to debt instruments within its scope not discussed here.

Troubled Debt Restructurings[11]

8.95 FASB Statement No. 15, as amended, establishes the accounting for troubled debt restructurings (TDRs). For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans.

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[10] See paragraph 3 of SOP 03-3 for a list of scope exceptions.

[11] The staff of the FASB issued FASB Staff Position (FSP) FAS 144-1, *Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15*, Accounting by Debtors and Creditors for Troubled Debt Restructurings, *and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets.

8.96 Outstanding loans whose terms have been modified in TDRs are accounted for under the provisions of FASB Statement No. 114, as amended by FASB Statement No. 118.[12]

8.97 ***Modifications of Terms.*** Paragraph 5(c) of FASB Statement No. 15 says that modifications of terms of debt may include one or a combination of the following:

a. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt

b. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk

c. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement

d. Reduction (absolute or contingent) of accrued interest

8.98 Creditors should account for modifications of terms of loans in accordance with FASB Statements No. 15 and No. 114. Accountants may also refer to the following EITF issues related to the modification of debt: EITF Issue No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*, EITF Issue No. 98-14, *Debtor's Accounting for Changes in Line-of Credit or Revolving Debt Arrangements*, EITF Issue No. 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*, and EITF Issue No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement No. 15*.

8.99 ***Receipts of Assets.*** Paragraph 28 of FASB Statement No. 15, as amended, says:

> A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph 13 of FASB Statement No. 15 for how to measure fair value). A creditor that receives long-lived assets that will be sold from a debtor in full satisfaction of a receivable shall account for those assets at their fair value less cost to sell as that term is used in paragraph 34 of FASB Statement No. 144. The excess of (i) the recorded investment in the receivable satisfied over (ii) the fair value of assets received (less cost to sell, if required above) is a loss to be recognized. For purposes of this paragraph, losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, shall be included in measuring net income for the period.

8.100 Paragraph 11.08 and the following discuss the accounting for and reporting of foreclosed assets established by FASB Statements No. 15 and No. 144.

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[12] Paragraph 27 of FASB Statement No. 114 allows institutions to continue to account for certain restructured loans in accordance with the provisions of FASB Statement No. 15 prior to its amendment by FASB Statement No. 144. Specifically, paragraph 27 applies if a loan that was restructured in a TDR involving a modification of terms before the effective date of FASB Statement No. 114 is not impaired based on the terms specified by the restructuring agreement.

8.101 Paragraph 34 of FASB Statement No. 15, as amended, requires that:

> A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39.

8.102 Paragraphs 28 and 33 of FASB Statement No. 15 are described in paragraphs 8.98 and 8.101 herein, respectively. Paragraph 39 of FASB Statement No. 15 says:

> A receivable from the sale of assets previously obtained in a troubled debt restructuring shall be accounted for according to *APB Opinion No. 21* regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that Opinion was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

8.103 ***Combination of Types.*** For TDRs involving receipt of assets (including an equity interest) in partial satisfaction of a receivable and a modification of terms of the remaining receivable, paragraph 33 of FASB Statement No. 15, as amended, requires that the assets received should be accounted for as prescribed in paragraph 28 of the Statement (see paragraph 8.97) and the recorded investment in the receivable should be reduced by the fair value less cost to sell of the assets received.

8.104 FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, clarifies that any loan that was restructured in a TDR involving a modification of terms, including those restructured before the effective date of FASB Statement No. 114, would be subject to the provisions of FASB Statement No. 115 if the debt instrument meets the definition of a security (as provided in FASB Statement No. 115). EITF Issue No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement No. 15*, provides guidance to determine whether FASB Statement No. 15 applies and is directly related.

8.105 EITF Issue No. 94-8, *Accounting for Conversion of a Loan Into a Debt Security in a Debt Restructuring*, discusses how to account for the difference between the recorded investment in a loan being restructured and the fair value of debt securities received at the time of conversion.

Real Estate Investments

8.106 The AICPA's "Notice to Practitioners on ADC Arrangements,"[13] requires that certain loans be accounted for as investments in real estate or real estate joint ventures, rather than as loans in situations where the lender has taken on virtually the same risks and potential rewards as an owner. Loans that are accounted for as real estate investments or joint ventures should not

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[13] The "Notice to Practitioners on ADC Arrangements," appears as Exhibit I in AICPA Practice Bulletin No. 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*.

be reported or accounted for as loans and are usually classified in other assets or other real estate owned. See Chapter 11.

Lease Financing

8.107 Accounting for leases by lessees and lessors is established by FASB Statement No. 13, *Accounting for Leases*,[14] as amended. The last amendment to this Statement essentially required sale-leaseback accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. Other interpretive pronouncements address additional circumstances.

Foreign Loans

8.108 Accounting for foreign loans is generally the same as for single-jurisdiction, domestic loans. However, unique issues arise regarding the accounting for restructured debt of developing countries and the recognition of interest income on such loans.

8.109 AICPA Practice Bulletin No. 4, *Accounting for Foreign Debt/Equity Swaps*, was issued in 1988 to address exchanges of public- or private-sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. Such transactions are referred to as *debt/equity swaps*. In a typical debt/equity swap, holders of U.S. dollars-denominated debt of a particular country convert that debt into approved equity investments in that country based on the official exchange rate at the time of the transaction. A discount from the official exchange rate is usually charged on the transaction. Such debt/equity swaps are considered exchanges of monetary assets for nonmonetary assets, which should be accounted for at fair value at the date on which both parties agree to the transaction. Because prices in the secondary markets for the debt of financially troubled countries may not be the best indicator of value, Practice Bulletin No. 4 also provides guidance on determining fair values of debt/equity swap transactions.

8.110 AICPA Practice Bulletin No. 5, *Income Recognition on Loans to Financially Troubled Countries*, was issued in 1988 to address whether an institution should credit receipt of interest payments on nonaccrual loans to the principal balance of the loan or to income when the loan has been placed on nonaccrual status.

Commitments

8.111 FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, provides guidance on the types of loan commitments that are derivatives under FASB Statement No. 133 (and therefore required to be accounted for as derivatives) and those that are excluded from the scope. Generally, only commitments to originate mortgage loans that will be held for sale by the issuer of the loan are derivatives under the scope of FASB Statement No. 133. For those loan commitments, derivative accounting is required by the issuer of the loan commitment (the writer of the option) but not the holder of the loan commitment (the potential borrower under the contract). All other commitments to originate loans are excluded from the scope of FASB

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[14] The staff of the FASB has issued FASB Staff Position (FSP) 13-1, *Accounting for Rental Costs Incurred during a Construction Period*, The guidance in this FSP shall be applied to the first reporting period beginning after December 15, 2005.

Statement No. 133 and are accounted for under FASB Statements No. 65 or No. 91, as appropriate. However, commitments to purchase or sell loans (forward contracts rather than option contracts) are generally derivatives included in the scope of FASB Statement No. 133. (Readers may also refer to DIG Issue C-13, *When a Loan Commitment Is Included in the Scope of Statement No. 133*, for further guidance).[15]

8.112 Commitments to originate mortgage loans that will be held-for-sale therefore are recorded at fair value at inception and changes in fair value are recorded in current earnings. Chapters 10 and 18 of this Guide address commitments to sell loans. Chapter 9, paragraphs 9.31 and subsequent paragraphs of this Guide address accounting for loss contingencies in conformity with FASB Statement No. 5. In addition, SEC Staff Accounting Bulletin (SAB) No. 105,[16]*Application of Accounting Principles to Loan Commitments* (Codification of Staff Accounting Bulletins, Topic 5(DD)), for entities filing with the SEC, provides required valuation and disclosure guidance for loans commitments accounted for as derivatives entered into subsequent to March 31, 2004.[17]

8.113 Entities sometimes enter into forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is at the option of the seller of the loans and would result in delivery to the entity only if the contract price equals or exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that the entity assumes all the market risks of ownership but shares in none of the rewards. A standby commitment is, in substance, a written put option that will be exercised only if the value of the loans is less than or equal to the strike price. Many entities use standby commitments to supplement their normal loan origination volume. Such standby commitments are subject to the scope of FASB Statement No. 133, *Accounting for Derivative and Hedging Activities*, if they satisfy the definition of a derivative in paragraph 6 and related paragraphs of that Statement. Standby commitments discussed in this paragraph that satisfy the definition of a derivative must be recognized in the statement of financial position at inception and measured at the fair value of the commitment. In accordance with paragraph 18 of FASB Statement No. 133, changes in fair value of derivative instruments not designated in hedging relationships must be recognized currently in earnings.[18]

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[15] Issues addressed by the Derivative Implementation Group (DIG) and the status of related guidance can be found at the FASB's Web site at www.fasb.org. See footnote 5 in paragraph 8.72 for a discussion of amendments to FASB Statement No. 133.

[16] The AICPA has issued a Practice Aid, *Illustrative Disclosures on Derivative Loan Commitments*, for comment. The Practice Aid provides illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in SAB No. 105.

[17] In May 2005, the OCC, FDIC, FRB, OTS and NCUA issued "Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans." This advisory provides guidance related to the origination of mortgage loans that will be held for resale, and the sale of mortgage loans under mandatory delivery and best efforts contracts.

[18] This paragraph applies only to standby commitments to purchase loans. It does not apply to other customary kinds of commitments to purchase loans, nor does it apply to commitments to originate loans. Paragraph 10(i) of FASB Statement 133, as amended, and FASB Statement No. 133 Implementation Issue C13, "When a Loan Commitment Is Included in the Scope of Statement 133," provides a scope exception for commitments to originate mortgage loans that will be held for investment purposes. However, that scope exception does not relate to commitments to purchase or sell loans. See footnote 5 in paragraph 8.72 for a discussion of amendments to FASB Statement No. 133.

Financial Statement Presentation and Disclosure

8.114 The FASB issued FSP FAS SOP 94-6-1, *Term Loans Products That May Give Rise to a Concentration of Credit Risk*. The guidance in this FSP is effective for interim and annual periods ending after the December 19, 2005. An entity shall provide the disclosures required by FASB Statement No. 107 for products that are determined to represent a concentration of credit risk in accordance with the guidance in Question 1 for all periods presented.

8.115 SOP 01-6, paragraphs 13(*a*) and (*c*), state that the summary of significant accounting policies should include the following:

- The basis of accounting for loans, trade receivables and lease financings, including those classified as held for sale.
- The classification and method of accounting for interest-only strips, other interests that continue to be held by the transferor in securitizations, loans, other receivables, or other financial assets that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment except for instruments that are within the scope of FASB Statement No. 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB Statement No. 115, as amended (paragraph 362).[19]
- The method used in determining the lower of cost or fair value of *nonmortgage* loans held for sale (that is, aggregate or individual asset basis).[20]
- The method for recognizing interest income on loans and trade receivables, including a statement about the entity's policy for the treatment of related fees and costs, including the method of amortizing net deferred fees or costs. (This disclosure should include the entity's policy for recognizing interest income on impaired loans, including how cash receipts are recognized, as required by paragraph 20 of FASB Statement No. 114, as amended.)
- The policy for placing loans (and trade receivables if applicable) on nonaccrual status (or discontinuing accrual of interest), recording payments received on nonaccrual loans (and trade receivables if applicable), and the policy for resuming accrual of interest.
- The policy for determining past due or delinquency status (that is, whether past due status is based on how recently payments have been received or contractual terms).
- The policy for charging off uncollectible loans and trade receivables.

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[19] Footnote 18 of FASB Statement No. 15 states that "The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous write-down of the investment." This disclosure requirement applies to instruments within the scope of paragraph 14 of FASB Statement No. 140. In March of 2006 the FASB issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. This Statement amends paragraph 14 of FASB Statement No. 140. For additional information see footnote 5 in paragraph 8.72.

[20] A similar requirement exists for mortgage loans held for sale. See paragraph 29 of FASB Statement No. 65, as amended.

8.116 SOP 01-6, paragraph 13(*e*), states that loans or trade receivables may be presented on the balance sheet as aggregate amounts. However, such receivables held for sale should be a separate balance-sheet category. Major categories of loans or trade receivables should be presented separately either in the balance sheet or in the notes to the financial statements. The allowance for credit losses, the allowance for doubtful accounts and, as applicable, any unearned income, any unamortized premiums and discounts, and any net unamortized deferred fees and costs should be disclosed in the financial statements.[21]

8.117 SOP 01-6, paragraph 13(*g*), states that the recorded investment in loans (and trade receivables if applicable) on nonaccrual status as of each balance-sheet date should be disclosed in the notes to the financial statements. The recorded investment in loans (and trade receivables if applicable) past due 90 days or more and still accruing should also be disclosed. For trade receivables that do not accrue interest until a specified period has elapsed, nonaccrual status would be the point when accrual is suspended after the receivable becomes past due. FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, an amendment of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, requires that a creditor disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an impairment loan in paragraph 8 of FASB Statement No. 114:

a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

8.118 Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 8.114*a* and 8.114*c* in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the

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[21] If the institution continues to account for certain restructured loans based on paragraph 27 of FASB Statement No. 114, it should include those disclosures required by paragraphs 40 and 41 of FASB Statement No. 15 prior to its amendment by FASB Statement No. 114. The staff of the FASB has also published a FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*.

loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 8.114*a* and 8.114*c* to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

8.119 For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and with this Statement.

8.120 SOP 01-6, paragraph 13(*i*), states that the carrying amount of loans, trade receivables, securities, and financial instruments that serve as collateral for borrowings should be disclosed pursuant to paragraphs 18 and 19 of FASB Statement No. 5.

8.121 FASB Statement No. 13 requires certain disclosures by lessors when leasing is a significant part of a lessor's business activities in terms of revenue, net income, or assets.

8.122 SOP 01-6, paragraph 14(*m*), states that for financial instruments with off-balance-sheet credit risk,[22] except for those instruments within the scope of FASB Statement No. 133,[23] an entity should disclose the following information:

a. The face or contract amount

b. The nature and terms, including, at a minimum, a discussion of the:

  (1) Credit and market risk of those instruments

  (2) Cash requirements of those instruments

  (3) Related accounting policy pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*

c. The entity's policy for requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

8.123 Examples of activities and financial instruments with off-balance-sheet credit risk include obligations for loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees, note issuance facilities at floating rates, and letters of credit.

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[22] Off-balance-sheet credit risk refers to credit risk on off-balance-sheet loan commitments, standby letters of credit, financial guarantees, and other similar instruments, except those instruments within the scope of FASB Statement No. 133, as amended.

[23] See footnote 5 in paragraph 8.72 for amendments to FASB Statement No. 133.

8.124 FASB Statement No. 107,[24] as amended, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. Paragraph 11 of FASB Statement No. 107 says, in part, that

> Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques.

8.125 Paragraph 26 of FASB Statement No. 107, as amended says, in part, that

> If no quoted market price exists for a category of loans, an estimate of fair value may be based on (*a*) the quoted market price of a financial instrument with similar traded loans with similar credit ratings, interest rates, and maturity dates, (*b*) current prices (interest rates) offered for similar loans in the institution's own lending activities, or (*c*) valuations obtained from loan pricing services offered by various specialist firms or from other sources.

8.126 FASB Statement No. 107, *Disclosures about Fair Value of Financial Statements*, as amended, requires disclosures about all significant concentrations of credit risk arising from all financial instruments except for the instruments described in paragraph 15b of FASB Statement No. 107. The following shall be disclosed for each significant concentration:

a. Information about the (shared) activity, region, loan products, terms of loan products, or economic characteristic that identifies the concentration

b. The maximum amount of loss due to credit risk that, based on the gross fair value of the financial instrument, the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity

c. The entity's policy of required collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

d. The entity's policy of entering into master netting arrangements to mitigate the credit risk of the financial instruments, information about the arrangements for which the entity is a party, and a brief description of the terms of those arrangements, including the extent

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[24] FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, as amended, makes the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

to which they would reduce the entity's maximum amount of loss due to credit risk

FASB Statement No. 107 also encourages disclosure about market risk of all financial instruments as described in paragraphs 15C and 15D of the Statement.[#]

8.127 If it is not practicable to estimate the fair value of a financial instrument or a class of financial instruments, FASB Statement No. 107, as amended, requires the disclosure of (*a*) information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity, and (*b*) the reasons why it is not practicable to estimate fair value.

8.128 FASB Statement No. 57, *Related Party Disclosures*, contains guidance on disclosures about transactions with various related parties. Institutions frequently make loans to parent and affiliated companies, directors, officers, and stockholders, as well as to entities with which directors, officers, and stockholders are affiliated. The aggregate amount of such loans should be disclosed.

8.129 As required by paragraph 40(b) of FASB Statement No. 15, institutions should disclose the amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructurings.

8.130 Accounting and financial reporting matters related to the sales or other dispositions of loans are addressed in Chapter 10.

8.131 FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*,[25] elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of the guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Commercial letters of credit and other loan commitments, which are commonly thought of as guarantees of funding, are not included in the scope of FASB Interpretation No. 45. The provisions of FASB Interpretation No. 45 apply to a financial standby letter of credit, which is an irrevocable undertaking (typically by a financial institution) to guarantee payment of a specified financial obligation. The provisions of FASB Interpretation No. 45 apply to other guarantee contracts as well. See paragraphs 2 through 7 of FASB Interpretation No. 45 for specific guidance regarding the scope of FASB Interpretation No. 45.

8.132 In accordance with paragraph 9 and 10 of FASB Interpretation No. 45, at the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee. The objective of the

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[#] The FASB recently issued Statement No. 157, *Fair Value Measurements*. Statement No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

[25] In addition to FASB Interpretation No. 45, the FASB staff issued two FASB Staff Positions (FSP): FSP FIN 45-2, *Whether FASB Interpretation No. 45*, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, *Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value*, that was effective immediately; and FSP FIN 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a business or Its Owners*. FSP FIN 45-3 should be applied for new minimum revenue guarantees issued or modified on or after the beginning of the first fiscal quarter following November 10, 2005.

initial measurement of the liability is the fair value of the guarantee at its inception. In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under FASB Statement No. 5 for the related contingent loss, the liability to be initially recognized for that guarantee shall be the greater of (*a*) the amount that satisfies the fair value objective or (*b*) the contingent liability amount required to be recognized at inception of the guarantee by paragraph 8 of FASB Statement No. 5. FASB Interpretation No. 45 does not prescribe a specific account for the guarantor's offsetting entry when it recognizes the liability at the inception of a guarantee. As stated in paragraph 11 of FASB Interpretation No. 45, that offsetting entry depends on the circumstances in which the guarantee was issued. The liability that the guarantor initially recognized would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee, as stated in paragraph 12 of FASB Interpretation No. 45.

8.133 Paragraph 13 of FASB Interpretation No. 45 requires a number of disclosures about a guarantor's obligations under guarantees. They include the nature of the guarantee, the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee, the current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee, and the nature of any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee.

Auditing

Objectives

8.134 The primary objectives of audit procedures in the loan area are to obtain reasonable assurance that:

a. Loans exist and are owned by the entity as of the balance-sheet date.

b. The allowance for credit losses is adequate for estimated losses that have been incurred in the loan portfolio. (Audit procedures to satisfy this objective are discussed in Chapter 9.)

c. Loans are properly classified, described, and disclosed in the financial statements, including fair values of loans and concentrations of credit risk.

d. Recorded loans include all such assets of the institution and the financial statements include all related transactions during the period.

e. Loan transactions are recorded in the proper period.

f. Loans held for sale are properly classified and are stated at the lower of cost or market value.

g. Interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees or costs) have been properly measured and recorded.

h. Gains and losses on the sale of loans have been properly measured and properly recorded.

i. Credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements.

j. Transfers of loans have been properly accounted for under FASB Statement No. 140.[26]

Planning ||

8.135 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*(AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements, which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to loans. As described earlier in this chapter, credit risk is normally the principal risk inherent in lending. The composition of an institution's loan portfolio, which can vary widely from institution to institution, is one of the most important factors in assessing the risk of material misstatement related to loans. For example, the risks associated with construction lending are very different from the risks associated with credit-card lending. The current year's interim financial statements and other financial information (for example, board of directors' minutes, asset-classification reports, credit management reports, and reports of the institution's regulators) should be helpful in understanding an institution's credit strategy and loan portfolio characteristics and, thereby, in assessing the related risk of material misstatement. Those reports generally include information about such items as dollar amounts and types of loans; the volume of current originations by type and related net deferred loan fees or costs; identification of TDRs; ADC arrangements; purchases and sales of loans, including gains and losses; and wash sales, among others. Controls over loans should also include controls over allowances and write-offs. Readers may refer to Chapter 9, "Credit Losses," for guidance. As stated in AU section 314, the independent accountant is required to perform risk assessment procedures to obtain an understanding of its environment, including this area.

8.136 The following factors related to loans may be indicative of risk of material misstatement (and, often, higher control risk) for loans and related amounts:

- Lack of a formal written lending policy
- High rate of growth in the loan portfolio
- Concentration of lending authority in one individual

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[26] See footnote 5 in paragraph 8.72.

|| In March 2006, the ASB issued eight SASs related to risk assessment. It is anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information. This guide will be updated to reflect these eight standards closer to their effective date

- Lack of personnel with skills and knowledge of a particular kind of loan, such as credit card or construction
- Significant changes in the composition of an institution's portfolio
- Poor underwriting standards and procedures
- Poor recordkeeping and monitoring of principal and interest receipts
- Significant nontraditional lending activities that involve a higher degree of risk, such as highly leveraged lending transactions
- Significant originations or purchases of loans outside the institution's normal activities or market area
- Sales of loans with significant recourse provisions
- Ambiguous transactions involving the sale or transfer of loans, especially when there is a lack of analysis prior to the transactions
- Failure of personnel to follow management's written lending policies for underwriting and documentation
- Loans that are continuously extended, restructured, or modified
- Loans that are of a type, customer, collateral, industry, or geographical location not authorized by management's written lending policies
- Loans of unusual size or with unusual interest rates or terms
- Significant concentrations of loans in a particular industry or geographic area
- The potential for insider abuse because of significant loans to the institution's officers, directors, shareholders, or other related parties that do not meet normal underwriting standards, such as nominee loans, loans with questionable collateral, and multiple transactions with a single related party or group of affiliated parties.
- Significant concentrations of loan products with terms that give rise to a credit risk; such as, negative amortization loans, loans with high loan-to-value ratios, multiple loans on the same collateral that when combined result in a high loan-to-value ratio, and interest-only loans.

Internal Control Over Financial Reporting and Possible Tests of Controls [27]

8.137 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), and AU section 319, establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS). It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatement. AU section 314 requires that, in all audits, the independent accountant obtain a sufficient understanding of each of the five components of

[27] See footnote 27 in paragraph 8.134.

internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

8.138 An understanding of the internal control over the financial reporting of loans should include controls over transactions such as granting credit, disbursing loan funds, applying loan payments, amortizing discounts, accruing interest income, purchased loans, participations, and syndications as those transactions relate to each significant type of lending activity. Also, procedures are needed to ensure that all appropriate liens have been filed.

8.139 Effective internal control over financial reporting in this area should provide reasonable assurance that errors or fraud in management's financial statement assertions about the loan portfolio—including those due to the failure to execute lending transactions in accordance with management's written lending policies—are prevented or detected. For example, failure to document a second lien as required by management's written loan documentation policy could affect financial statement assertions about ownership and valuation.

8.140 Factors that contribute to an effective control environment may include:

- Those charged with governance take an active role in monitoring lending policies and practices
- Information systems which enforce the segregation of duties and the monitoring of activities, and maintain the integrity of information on which management relies upon to identify problem loans
- A well-defined lending approval and review system that includes established credit limits, limits and controls over the types of loans made, and limits on maturities of loans
- A reporting system that provides the institution with the information needed to manage the loan portfolio

8.141 In obtaining an understanding of the entity and its environment, including its internal controls, the independent accountant should obtain an understanding about the institution's accounting system as it relates to loans receivable, including the methods used by the institution when processing and recording new loans, applying loan payments, accruing interest, and amortizing discounts.

8.142 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Typical controls relating to loans include the following:

- All loans and credit lines (including all new loans, renewals, extensions, and commitments) are approved by officers or committees in conformity with management's written lending policies and authority limits.

- An inventory of required loan documents, including evidence of collateral and of the recording of liens, is monitored to ensure the timely receipt of required documents.
- Pertinent loan information is entered into the data-processing system on a timely basis and is independently verified to ensure accuracy.
- Subsidiary ledgers and trial balances are maintained and reconciled with the general ledger on a timely basis, differences found are investigated and resolved, and appropriate supervisory personnel review and approve completed reconciliations on a timely basis.
- Loans held for sale are properly identified in the accounting records.
- Payments due for principal or interest are monitored for their eventual receipt, aging of delinquencies, and follow-up with late payers.
- There is segregation of duties among those who *(a)* approve loans, (*b*) control notes and collateral, (*c*) receive payments, *(d)* post subsidiary ledgers, and (*e*) reconcile subsidiary and general ledgers.
- Procedures are periodically performed to ensure that interest income is properly accrued and recorded.
- Notes and collateral on hand are kept in secure, locked, fireproof compartments. Negotiable collateral is kept under dual access control. Physical inventory and other processes are in place to identify losses or impairment of collateral.
- Construction loan advances are adequately documented, and periodic on-site inspections of properties are made to ensure construction progress is consistent with amounts advanced.

8.143 ***Loan Files.*** Complete and accurate loan files are an element of internal control over financial reporting of loans. Paragraph 8.141 details information that may be found in a loan file. The contents of the files vary, depending on the type of loan, the requirements of local law, and whether the institution intends to hold the loan or not. However, all loan files should contain a signed note. An inspection of the files supporting loans originated in prior audit periods, as well as new loans (including some of the loans still in the process of disbursement), generally permits the independent accountant to understand the institution's internal control in this area as a basis for planning substantive tests. It may also be useful to design dual-purpose tests in this area.

8.144 Following are items a loan file may contain. The location of the contents listed will vary from one institution to another depending on the type of loan and a particular institution's policies and procedures:

a. Credit investigation/application/supervision section

(1) Loan application

(2) Credit approval document that summarizes:

- Borrower
- Amount of request, rate, payment terms, and fees
- Purpose
- Repayment sources (primary and secondary)

- Collateral description and valuation
- Guarantors
- Other conditions and requirements of approval

(3) Evidence of loan committee or other required approval and date approval was granted

(4) Financial statements of borrower, guarantor, or both

(5) Spreadsheets and other analyses of the financial situation of the borrower

(6) Borrower's board resolutions concerning loan approval

(7) Credit agency reports and other account information reports, as well as direct trade creditor references

(8) Newspaper clippings about borrower

(9) Various other pertinent data, including the borrower's history and forecasts

(10) Internal memoranda

(11) Correspondence

(12) Loan summary sheet, containing information such as:

- Lending committee approval date
- Drawdown amounts and dates
- Interest rates and adjustment dates
- Amount of undrawn commitment
- Rate of commitment fee and due dates
- Date commitment fee received
- Repayment terms
- Name of country risk
- Name and country of any guarantor
- Amount of participation fee (if applicable)
- Indication of overdue payments of interest, fees, or installments

(13) Memorandum to the file, by the lending officer, with description of the credit and commentary on its quality and potential future developments

b. Loan documents section, including:

(1) Signed loan agreement

(2) Legal opinion

(3) Signed note

(4) Signed mortgage or deed of trust, with evidence of recordation

(5) Signed guarantee

(6) Periodic report of collateral, including its location and value and any related environmental studies

(7) Participation certificates and participation agreements (if applicable)

(8) Evidence of insurance, including loss payable clauses that protect the bank's interest

(9) Approvals

(10) Security agreements or other collateral pledge agreements, titles, or financing statements recorded in the proper jurisdictions to perfect lien position (nonpossessory collateral); negotiable collateral (such as stocks and bonds) with proper endorsements/assignments; hypothecation agreement for third-party pledge of collateral

(11) Collateral ledger used to record the instruments (including stocks and bonds, which are probably kept in a vault separate from loan files or with an independent custodian) that secure a borrower's indebtedness.

8.145 For commercial loans, a credit file is commonly maintained. This file usually contains the borrower's financial statements, memoranda about the borrower's financial or personal status, financial statements of guarantors (individual or corporate), internally prepared analyses of the credit, copies of supplemental agreements between the institution and the borrower, and other loan-related correspondence.

8.146 Files supporting either direct or indirect installment loans should generally include the borrower's application, discount sheet (loan computations), credit information, title or financing statement, evidence of the existence of an in-force insurance policy payable to the institution, and the note. Credit files are also maintained on dealers from whom the institution has purchased loan paper.

8.147 Mortgage loan files generally include the note, loan application, appraisal report, verifications of employment and assets, deed of trust, mortgage, title insurance or opinion, insurance policy, settlement statement, and VA guarantee or FHA insurance, if applicable.

8.148 Specific procedures the independent accountant should consider performing to test the operating effectiveness of controls for loans include:

- Inspect loan documents to determine whether the institution's lending policies and procedures are being followed, for example, to test whether:

  a. Loans are being approved by authorized officers or committees in accordance with the institution's lending policies.

  b. Credit investigations are performed.

  c. Credit limits are adhered to.

  d. The institution's procedure to capture all required loan documents is functioning.

  e. The information recorded in the institution's data-processing system and used for management reporting is being tested by personnel independent of the preparer and is accurate.

- Test the institution's reconciliation process. This testing might include the daily activity balancing process as well as the reconciliation of subsidiary ledgers with the general ledger. The independent accountant should test whether reconciling differences are appropriately investigated and resolved in a timely manner and whether the reconciliations are reviewed and approved by appropriate supervisory personnel.

- Test the accuracy and performing a review of delinquency reports to determine whether the institution initiates follow-up procedures on delinquent loans in accordance with its policies and whether the system identifies potentially troubled loans for purposes of assessing impairment.
- Check the accuracy and perform a review of concentration reports (such as loans to one borrower, in a particular region, or in a specific industry) and related-party loan reports.
- Review internal audit, loan review, and examination reports to identify control weaknesses and exceptions.
- Observe or otherwise obtain evidence that a proper segregation of duties exists among those who approve, disburse, record, and reconcile loans.
- Perform detailed tests of initial recording of loans, application of cash receipts, and changes in loan details (such as adjustment of rates for ARMs and maturity dates).

8.149 ***Credit-Card Activities.*** To the extent the institution is involved in credit-card operations, including credit-card issuance and the processing of transactions, the independent accountant should consider internal control over financial reporting of credit-card activities. Audit procedures for testing financial statement assertions related to credit-card activities depend on the degree of the institution's involvement in such activities. If the institution owns the customer receivables, the following may be appropriate:

- Review lending policies.
- Confirm customer balances.
- Test interest and service charges, collections, delinquencies, and chargeoffs may be appropriate.

If the institution only processes merchants' deposits and the resulting receivables are owned by other institutions, a review of the arrangements and a test of service fee income is generally performed.

8.150 ***Audits Performed in Accordance With PCAOB Standards.***[**] Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 (AICPA, *Professional Standards*, vol. 1) for a discussion on the extent of test of controls. Also, refer to Audit Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the

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[**] In December 2006, the PCAOB proposed Release No. 2006-07, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*, and Related Other Proposals, that would supersede AS2 and all other previous PCAOB guidance related to that standard. See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 5.

Board, "Standards"), for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing decisions.

8.151 As discussed in Chapter 5, to the extent the institution relies on other enterprises for some processing activities, the independent accountant should consider the guidance in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).[27] When performing an integrated audit, refer to Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), regarding the use of service organizations.

Substantive Tests

8.152 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to loans.

8.153 The independent accountant should determine the nature, timing, and extent of substantive tests based the assessment of the risks of material misstatement. Substantive tests that the independent accountant should consider follow.

8.154 ***Analytical Procedures.*** AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of analytical procedures. In performing these procedures, the independent accountant should be careful not to review trends entirely from a historical perspective; current environmental and business factors, as well as local, regional, and national trends, should be considered in determining whether the institution's trends appear reasonable. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document the following:

a. the expectation where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development;

b. results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts; and

c. any additional procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.

8.155 Analytical procedures that the independent accountant may apply in the loan area include the analysis and evaluation of the following:

- Changes in the mix between different types of loans in the portfolio
- Comparison of the aging of past-due loans with similar aging of prior year

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[27] The Auditing Standards Board (ASB) has issued an Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended.* The Guide includes illustrative control objectives as well as interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

- Comparison of loan origination volume by month with that of prior periods
- Current-year income compared with expectations and prior-year income
- Average loan balances by type in the current year compared with those of the prior year
- Comparison of yields on loans to the institution's established lending rates or pricing policies
- Reasonableness of balance-sheet accruals based upon underlying terms and amounts of corresponding loans
- Average yield throughout the period computed for each loan category on a monthly or quarterly basis

8.156 In using analytical procedures as a substantive test, the independent accountant should consider the implications of changes in important relationships and the extent of the difference between actual and expected results that can be accepted without further investigation. It is normally difficult to develop expectations to be used in analyzing yields on aggregated loans as a substantive test of related income amounts. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision (i.e., using computer-assisted audit techniques).

8.157 When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

8.158 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), requires auditors to obtain audit evidence about the completeness and accuracy of nonfinancial information if the auditor uses such information in performing audit procedures.

8.159 For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

8.160 ***Subsidiary Records.*** The independent accountant should obtain detailed schedules of loan principal balances and related accounts (accrued interest receivable, unearned discount, and net deferred loan fees and costs) and reconcile balances with the trial balance, general ledger, and other subsidiary records. The independent accountant should test significant reconciling items.

8.161 ***Confirmation.*** Guidance on the extent and timing of confirmation procedures is found in AU section 350, *Audit Sampling*[||] (AICPA, *Professional Standards*, vol. 1). Guidance on planning, performing, and evaluating samples is included in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*[||] (AICPA, *Professional Standards*, vol. 1). AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), discusses the relationship of confirmation procedures to the assessment of audit risk, the design of confirmation requests, the performance of alternative procedures, and the evaluation of confirmation results. AU section 330 stresses the importance of understanding the substance of transactions when determining information to include on confirmation requests and sets forth criteria that must be met for the use of negative confirmations. AU section 330 also establishes a presumption that the independent accountant will select a sample of loans for confirmation unless certain conditions are met.

8.162 In designing confirmation requests, the independent accountant should consider the types of information respondents will be readily able to confirm, because the nature of the information being confirmed may directly affect the competence of the evidence obtained as well as the response rate. For example, respondents may not be able to confirm the balances of installment loans, but they may be able to confirm whether their payments are up-to-date, the amounts of the payments, the interest rate, and the term of their loans.

8.163 Independent accountants may use either positive or negative requests to confirm loans. AU section 330 indicates that negative forms may be used when (*a*) the combined assessed level of inherent and control risk is low, (*b*) a large number of small balances is involved, and (*c*) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration. Auditors should consider performing other substantive procedures to supplement the use of negative confirmations. Positive confirmation procedures should be used for larger loans and for loans that require additional assurance or other related information in addition to the loan balance, such as amount and type of collateral.

8.164 ***Inspecting Loan Documents.*** Loan files vary considerably in content depending on the type of loan. Inspection of loan documents may provide evidence about the existence and ownership of the loan. If performing an inspection of loan documents, the independent accountant should be alert to notations or other indications of problems that merit further investigation or follow-up. When loan documents are in the possession of an attorney or other outside parties, the independent accountant should consider confirming the existence and ownership of such documents.

8.165 When inspecting loan documents, the independent accountant should consider testing the physical existence and reading any evidence of assignment to the institution of the collateral that supports collateralized loans. For certain loans, the independent accountant should consider inspecting collateral in the custody of the borrower, such as floor-plan merchandise. However, the independent accountant may conclude that a review of the reports of institution personnel who inspect collateral is sufficient audit evidence. The independent accountant should also consider examining or requesting confirmation of collateral not on hand. An inspection of loan documentation should

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[||] See footnote || in paragraph 8.91.

include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral.

8.166 While inspecting loan documents, the independent accountant should consider the audit objectives discussed in Chapter 9. For example, for guaranteed loans, the independent accountant should read the financial statements and other evidence of the financial condition of cosignatories and guarantors and consider the institution's historical experience with enforcing guarantees.

8.167 While inspecting loan documents, the independent accountant should look for evidence of approvals by the board of directors or loan committee as required by management's written lending policies, a comparison of loan amounts with appraisals, and an inspection of whether hazard and title coverage meets coverage requirements set in management's written policy. For loans generated under certain governmental programs and other special arrangements, the independent accountant may be engaged to perform the additional procedures required under the specific trust or servicing agreement.

8.168 ***Construction Loans.*** Audit procedures should be responsive to the institution's construction lending practices. The independent accountant should consider performing tests to determine whether construction loans are properly classified as loans rather than real estate investments. The independent accountant should consider testing origination, approval, inspection, and disbursements made based on progress on the particular construction project. The independent accountant should consider performing on-site inspections of significant construction projects to review the collateral and to determine whether construction has progressed in accordance with the loan terms.

8.169 ***Lease Financing.*** When confirming basic lease terms, the confirmation requests should include cancellation provisions, if any. Confirmation should ordinarily be requested from the lessee. For leveraged leases, the material aspects of the lease agreement, including information required for income tax purposes, may be requested from the lease trustee. Although alternative methods may be used for reporting income for tax purposes, the independent accountant should determine that income for book purposes is being recorded in conformity with FASB Statement No. 13.[28]

8.170 ***Whole Loans or Participations Purchased.*** Audit procedures for purchased loans should be similar to those for direct loans, except that requests for the confirmation of balances, collateral, and recourse provisions, if any, are usually sent to the originating or servicing institution. Loan files for purchased participations should be available at the institution and should contain pertinent documents, or copies of them, including credit files supporting loans in which the institution has purchased participations from other banks or savings institutions. The independent accountant should consider confirming the actual status of borrower payments with the servicer. Although it is usually not practicable to confirm balances of serviced loans with the individual borrowers, the servicer's independent accountants often perform audit procedures on individual loans, such as confirmation with borrowers and examination of loan documents. AU section 324 provides guidance to independent accountants of a

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[28] See paragraph 8.105.

service organization on issuing a report on certain aspects of the service organization's internal control that can be used by other independent accountants and provides guidance on how other independent accountants should use such reports. The independent accountant should obtain copies of any reports issued under AU section 324 by the servicer's independent accountants when planning the extent of test work necessary in the loan area. Depending on the nature and type of the report, audit procedures performed at the servicer's site may be necessary. In some cases, the independent accountant may wish to request certain information, such as the scope and findings of the audit procedures performed by the servicer's independent accountants, directly from the servicer's independent accountant. The independent accountant should also consider reviewing the institution's files on the servicer to observe the general reliability of the servicer. The latest remittance report from the servicer should be reconciled with the records of the institution.

8.171 ***Accrued Interest Receivable and Interest Income.*** Provided that a basis exists to rely on loan data recorded in the loan accounting system, interest income may be tested using computer-assisted audit techniques, the recomputation of accrued amounts for individual accounts, analytical procedures, or some combination thereof. If interest rates were relatively stable during a period, interest income can often be tested effectively by using analytical tests by type of loan. The independent accountant should consider average balances in principal accounts, related yields as compared to averages of rates offered and of rates on existing loans, and other factors and relationships. As discussed in paragraph 8.150 of this chapter, the effectiveness of such analytical procedures may vary.

8.172 ***Computer Assisted Audit Techniques.*** Computer-assisted audit techniques may also be used to perform "exception/limit" checks of individual files for unusual or questionable items meriting further investigation. Examples include identifying unusual interest rates, balances, and payments, or testing the accuracy of delinquency reports.

8.173 ***Balance-Sheet Classification of Loans.*** The independent accountant should consider whether any portion of loans is being held for sale and, therefore, whether a corresponding valuation allowance or write-down to lower of cost or market value is necessary. Previous loan sale activity, types of loans sold, transactions subsequent to year-end, pending contracts, and management's intentions are factors that should be considered in identifying loans held for sale.

8.174 ***Loan Fees and Costs.*** The independent accountant should consider reviewing and testing the propriety of the institution's deferral of loan origination fees and costs in accordance with FASB Statement No. 91, as well as evaluating the impact of not deferring loan costs and fees. The independent accountant should also consider performing a test of the amortization of net deferred loan fees or costs.

8.175 ***Undisbursed Portion of Mortgage Loans.*** Financial institutions sometimes record loans at the gross amount with an offsetting account entitled loans in process (LIP). As funds are disbursed, the LIP account is reduced. Interest or fees on construction loans also may be debited to this account. The LIP account should be cleared when the loan is fully disbursed. LIP detailed ledgers should be reviewed to determine the propriety of accounting, including that for complex interest calculations. Unusual LIP balances, such as debit balances or balances outstanding for an excessive period of time (for example, over a year), may be indicative of problem loans.

8.176 A review of the LIP detailed activity may be performed in connection with the examination of the current-year loan files. Loans selected for testing may be traced to the LIP account. Construction loans selected for testing may be traced to the LIP ledger, and disbursements may be reviewed in connection with the percentage of completion noted on inspection reports. In addition, if loan fees or interest are being capitalized (added to the loan balance) during construction, a review of the LIP ledgers may point out areas of concern. The independent accountant should consider whether to send confirmations to the borrower on any undisbursed loan balances.

8.177 ***Troubled Debt Restructurings.*** The independent accountant should consider performing procedures to identify TDRs and evaluate whether they have been accounted for in conformity with FASB Statements No. 15 and No. 114. Such tests may include procedures to determine whether possession of collateral has been taken as part of a TDR that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place (as discussed in paragraph 34 of FASB Statement No. 15, as amended).

8.178 For loans for which there is a market price, the independent accountant may test fair-value disclosures by reference to third-party market quotations, including information received from brokers or dealers in loans. Fair-value estimates of loans for which there is no market price are highly subjective. There are a variety of methodologies that may be used by institutions to estimate fair values of loans. Most derive a fair value by discounting expected cash flows using appropriate interest rates. Some methodologies are relatively simple, such as methods that derive much of their data from the information used in estimating the allowance for credit losses, and some are relatively complex, such as option pricing models. As with all accounting estimates, the independent accountant's objective is to obtain sufficient competent audit evidence to provide reasonable assurance that the fair-value estimates are reasonable in the circumstances and that they are presented in accordance with generally accepted accounting principles, including proper disclosure. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides relevant guidance. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on auditing fair-value measurements and disclosures contained in financial statements. In particular, AU section 328 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Also, the AICPA nonauthoritative publication, *Auditing Estimates and Other Soft Accounting Information*, provides guidance for auditing estimates. The independent accountant may decide to use the work of a specialist in assessing the entity's fair value estimates. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on using the work of a specialist. As described in paragraphs 5.67 through 5.74, the guidance of AU section 336 applies when an independent accountant uses a specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

Chapter 9

Credit Losses*

Introduction

9.01 Financial institutions accept and manage significant amounts of credit risk. Loans and underlying collateral have traditionally been the source of most credit losses incurred by financial institutions. The allowance for loan losses is an accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of the balance-sheet date.

9.02 Institutions may also have off-balance-sheet financial instruments, such as commitments to extend credit, guarantees, and standby letters of credit that are subject to credit risk. Though liabilities related to credit losses associated with such off-balance-sheet instruments are not part of the allowance for loan losses, institutions' processes for evaluation and estimation of the credit losses may include consideration of credit risk associated with those off-balance-sheet instruments, especially when the counterparty to an off-balance-sheet instrument is also a borrower. The information and guidance in this chapter, while generally referring to *loan* losses, may equally be useful in evaluating and estimating credit losses for off-balance-sheet instruments.

9.03 Chapter 8, "Loans," discusses the various kinds of loans institutions make or purchase, the lending process and related internal controls, financial reporting for loans, and audit procedures for loans. However, because of the significance to an institution's financial statements of the allowance and the provision for loan losses and any separate liability for other credit losses, the high degree of subjectivity involved in estimating these amounts, the high degree of regulatory guidance and oversight directed toward institutions' estimates of credit losses, and, consequently, the relatively high inherent audit risk associated with auditing such estimates, careful planning, and execution of audit procedures is essential in this area.

Management's Methodology

9.04 Management is responsible for estimating credit losses. Estimating credit losses is unavoidably subjective, and, accordingly, management must make careful judgments about collectibility and estimates of losses. Management's judgments should consider micro- and macro-economic factors; past, current, and anticipated events based on facts in evidence at the balance-sheet date; and realistic courses of action it expects to take.

9.05 An institution's method of estimating credit losses is influenced by many factors, including the institution's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. Although different institutions may use different methods, there are certain

* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

common elements that should be included in any methodology for it to be effective. The method should:

a. Include a detailed and regular analysis of the loan portfolio and off-balance-sheet instruments with credit risk.

b. Include procedures for timely identification of problem credits.

c. Be used consistently.

d. Consider all known relevant internal and external factors that may affect collectibility.

e. Consider all loans (whether on an individual or pool-of-loans basis) and other relevant credit exposure.

f. Consider the particular risks inherent in the different kinds of lending.

g. Consider current collateral fair values, where applicable.

h. Be performed by competent and well-trained personnel.

i. Be based on current and reliable data.

j. Be well documented, with clear explanations of the supporting analyses and rationale.

9.06 Methods that rely solely on mathematical calculations, such as a percentage of total loans based on historical experience or the similar allowance percentages of peer institutions, generally fail to contain the essential elements, because they do not involve a detailed analysis of an institution's particular transactions or consider the current economic environment.

9.07 As discussed below, creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Each segment should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan.

9.08 A key element of most methodologies is a credit classification process. The classification process involves categorizing loans into risk categories. The categorization should be based on relevant information about the ability of borrowers to service their debt, such as current financial information, historical payment experience, credit documentation, public information, and current trends. Many institutions classify loans using a rating system that incorporates the regulatory classification system.[1] These definitions are as follows:

a. *Substandard*. Loans classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

b. *Doubtful*. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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[1] See *Interagency Policy Statement on Review and Classification of Commercial Real Estate Loans*, June 10, 1993.

c. *Loss*. Loans classified as loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but, rather, that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

9.09 Some loans are also identified for a special mention. Such a loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or of the institution's credit position at some future date. Special-mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

9.10 Examples of such potential weaknesses are:

- Poor lending practices that result in significant defects in the loan agreement, security agreement, guarantee agreement, or other documentation and the deteriorating condition of or lack of control over collateral (In other words, these are conditions that may jeopardize the institution's ability to enforce loan terms or that reduce the protection afforded by secondary repayment sources.)
- Lack of information about the borrower or guarantors, including stale financial information or lack of current collateral valuations
- Economic or market conditions that in the future may affect the borrower's ability to meet scheduled repayments (These may be evidenced by adverse profitability, liquidity, or leverage trends in the borrower's financial statements.)

9.11 Institutions generally analyze large loans and loans not conducive to pool analysis on an individual basis by classifying the loans as to credit risk and estimating specific losses. This analysis may be performed by loan officers subject to review by an internal loan review department, or may be performed by a loan review department. The loan review focuses on determining whether individual loans are properly classified as to credit risk and were made in accordance with the institution's written lending policies and whether the borrower is likely to perform in accordance with its contractual terms and conditions. The review typically includes analysis of (*a*) loan performance since origination or the last renewal, (*b*) the current economic situation of a borrower or guarantor, and (*c*) estimates of current fair values of collateral. Borrower and guarantor financial statements are generally reviewed as to financial resources, liquidity, future cash flows, and other financial information pertinent to the ability to repay the debt. Collateral is reviewed to determine whether it is under the institution's control, whether security interests have been perfected (which is a legal determination), and whether the value is greater than the amount owed. Loan file contents are generally reviewed for completeness and conformity with the institution's written policies for loan documentation. The lack of an internal loan review and classification system may be considered to be an unsafe and unsound practice by regulators. For audits of nonissuers, the absence of an internal loan review function may constitute a reportable condition or material weakness, as defined in AU section 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1). For audits of issuers, the lack of an internal loan review function may constitute a significant control deficiency or material weakness, as defined in AU section 325 and Auditing Standard No. 2 paragraphs 207–214 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards").

9.12 Foreign loans should be reviewed but they require special consideration because of the transfer risk associated with cross-border lending. Certain foreign loans are required by the Interagency Country Exposure Risk Committee (ICERC) pursuant to the International Supervision Act of 1983 to have allocated transfer risk reserves (ATRRs). ATRRs are minimum specific reserves related to loans in particular countries. Such reserves are minimums, and institutions may determine that a higher allowance is necessary based on its assessment of the probable losses.

Groups of Homogeneous Loans and Leases

9.13 Loans not evaluated individually are included in groups of homogeneous loans. The focus of the pool approach is generally on the historical loss experience for the pool. Loss experience, which is usually determined by reviewing the historical loss (chargeoff) rate for each pool over a designated time period, is adjusted for changes in trends and conditions. Trends and conditions that the institution should consider in determining how historical loss rates should be adjusted include—

- Levels of and trends in delinquencies and impaired loans
- Levels of and trends in recoveries of prior chargeoffs
- Trends in volume and terms of loans
- Effects of any changes in lending policies and procedures
- Experience, ability, and depth of lending management and other relevant staff
- National and local economic trends and conditions
- Credit concentrations

Estimating Overall Credit Losses

9.14 Institutions may use a method that results in a range of estimates for the allowance for individual loans and large groups of loans and must apply careful judgment regarding the risks as well as other relevant factors for each segment of loans to determine the amount to record. Paragraph 3 of Financial Accounting Standards Board (FASB) Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, states, "when some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued." (However, the measure of impairment under FASB Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended, is based on a single best estimate and not a range of estimates.) The institution's conclusions about the appropriate amount should be well documented. Readers should refer to SEC Staff Accounting Bulletin (SAB) No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, and the FFIEC policy statement for further guidance regarding documentation issues.

9.15 Management often considers credit losses associated with certain off-balance-sheet financial instruments (such as commitments to extend credit, guarantees, and letters of credit) at the same time it considers credit losses associated with the loan portfolio. Although it is generally practical to consider credit losses on loans and other financial instruments at the same time, allowances necessary for off-balance-sheet instruments should be reported separately as liabilities and not as part of the allowance for loan losses.

9.16 Management should consider its overall loan loss allowance and liability for other credit exposures to be appropriate in accordance with GAAP only if such amounts are considered appropriate in accordance with GAAP to cover estimated losses inherent in the loan portfolio and the portfolio of other financial instruments, respectively. An illustration of a worksheet for an allowance and liability calculation is shown in Exhibit 9-1, "Worksheet for Estimating Credit Losses."

Exhibit 9-1

Worksheet for Estimating Credit Losses

Category	Recorded Investment †	Estimated Credit Loss Amount* High	Estimated Credit Loss Amount* Low
	$	$	$
Allowance for Estimated Loan Losses			
I Individually evaluated for impairment: ‡			
Impairment identified ‖			
No impairment identified		N/A	N/A
II Large groups of smaller-balance homogeneous loans collectively evaluated for impairment: #			
Credit card			
Residential mortgage			
Consumer			
Other			
III Other large groups of loans containing unidentified, impaired loans **			
IV Loans measured at fair value or at the lower of cost or fair value (2)		N/A	N/A
Total allowance for estimated loan losses		$	$
Liability for Losses on Credit Instruments and Other Credit Exposures			
Standby letters of credit (1)			
Commitments (1)			
Loans sold with recourse			
Losses on guarantees (FIN 45)			
Other			
Total liability for credit instruments and other credit exposures		$	$

* For purposes of this worksheet the estimated credit loss amount may be a specific amount or a range of estimated amounts. However, the measure of impairment under FASB Statement No. 114, as amended, is based on a single best estimate and not a range of estimated amounts.

† The total of amounts in this column generally should correspond to the institution's total loan (and lease) portfolio.

‡ This category includes loans evaluated for impairment in conformity with FASB Statement No. 114, as amended.

|| This subcategory includes loans for which it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement and, accordingly, for which impairment is measured in conformity with FASB Statement No. 114, as amended.

This category comprises large groups of smaller-balance homogeneous loans and leases that are collectively evaluated for impairment.

** This category comprises large group of all other loans and leases not addressed in categories I or II and not individually considered impaired but that, on a portfolio basis, are believed to have some inherent but unidentified impairment.

(1) If subject to the scope of FASB Statement No. 133, standby letters of credit and commitments should be excluded from the analysis. Credit exposure for instruments within the scope of that Statement is captured by the fair value measurement of the instrument.

(2) Users of this worksheet should be aware that the FASB has issued two statements that affect fair value. They are Statement No. 157, *Fair Value Measurements*, and Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment to FASB Statement No. 115.*

9.17 Loan evaluations by management (and tests of such by independent accountants to the extent they are performed as part of the engagement) should avoid the following:

- *Collateral myopia.* This is the failure to see beyond collateral values to a financial weakness in the borrower. Collateral values and liquidity often tend to decline in periods during which they are most needed to protect against loan losses. For example, if an oversupply in the real estate market causes lower-than-projected occupancy rates (creating cash flow problems for the borrower), the protection afforded by the collateral is diminished. Similar scenarios can be drawn for oil and gas reserves when energy prices decline, for specialized equipment (for example, drilling rigs, mining equipment, farm equipment, steel mills, and construction equipment) during specific industry slowdowns, for farmland during periods of depressed agricultural commodity and livestock prices, and for accounts receivable of a failing company.
- *Inadequate collateral appraisals.* This is the failure to critically review appraisals to understand the methods employed, assumptions made, and limitations inherent in the appraisal process, including undue reliance on management appraisals. Appraisal methods and assumptions may be inappropriate in the current circumstances. Going concern values generally are dramatically different from liquidation values. For example, real estate appraisals made on the income approach are not usually appropriate for incomplete projects or in circumstances in which operating conditions have changed.

- *Outdated or unreliable financial information.* This is the reliance on old, incomplete, or inconsistent data to assess operating performance or financial capacity. Financial information should be current and complete, particularly for borrowers sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets.
- *Excessive renewals or unrealistic terms.* This is the reliance on current or performing-as-agreed status if the transaction has been structured to obscure weaknesses. Excessive renewals, unrealistic terms, and interest capitalization may be indications of such a structure. The purpose of a loan and performance against the original agreement should be critically reviewed.
- *Personal bias.* This is the bias of a reviewer for or against industries, companies, individuals, and products. For example, the involvement of a public personality in a venture could influence a reviewer to place more credibility than appropriate on the success of the venture.
- *Overlooking self-dealing.* This concerns directors or large shareholders who improperly use their position to obtain excessive extensions of credit on an unsound basis. In this situation, management is often unduly influenced by persons in these positions since management serves at the pleasure of the board and shareholders.
- *Dependence on management representations.* This is undue reliance on management representations even though there is no supporting evidence. For example, such representations as "the guarantee is not signed but it is still good" or "the future prospects for this troubled borrower are promising" should be critically reviewed.

Regulatory Matters

9.18 The federal banking agencies' July 6, 2001, *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* discusses (*a*) the nature and purpose of the allowance, (*b*) the related responsibilities of the board of directors and management and of the examiners, (*c*) loan review systems, and (*d*) international transfer risk matters. Included in the discussion of examiner responsibilities is an analytical tool for assessing the reasonableness of management's loss allowance methodology. The tool involves comparison of the reported loss allowance against the sum of specified percentages (based on industry averages) applied to certain loan classifications. Related regulatory guidance strongly cautions examiners against using the tool as a rule of thumb or as a substitute for a full and thorough analysis of the bank's loan portfolio, in part because such comparisons do not take into account the often-significant differences between institutions, their portfolios, underwriting and collection practices, and credit-rating policies.

9.19 On March 1, 2004, the FRB, FDIC, OCC, OTS, and NCUA issued *Update on Accounting for Loan and Lease Losses* (ALLL), which addressed accounting for loan and lease losses. Among other matters, the issuance identifies the current sources of GAAP and supervisory guidance regarding allowances for loan and lease losses that institutions should continue to apply. The following describes the financial institutions responsibilities associated with the *Update for the Allowance for Loan and Lease Losses*:

- Maintain adequate controls to ensure the ALLL is consistently determined in accordance with GAAP, stated policies and procedures, and relevant supervisory guidance.
- Develop, maintain, and document a comprehensive, and consistently applied process to determine the amounts of the ALLL and provisions for loan and lease losses.
- Maintain an ALLL at a level that is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio, consistent with long-standing supervisory guidance.
- Utilize prudent, conservative, but not excessive, judgment to determine ALLL that represents management's best estimate from within an acceptable range of estimated losses.

9.20 The determination of loan loss allowances is necessarily a highly subjective process. Accordingly, management's use of the specified percentages as the primary basis for establishing loss allowances ordinarily would be questionable. Independent accountants should be alert to the risk that management may, inappropriately, rely on the tool to establish the loss allowance for certain loans instead of gathering the information and applying the judgment necessary to determine the appropriateness in accordance with GAAP of the loss allowance for those loans. In such circumstances, independent accountants should ask management to verify that loss allowances have been established in conformity with generally accepted accounting principles (GAAP) rather than in accordance with the specified percentages.

9.21 The Office of the Comptroller of the Currency (OCC) provides regulatory and accounting guidance to its examiners in its June 1996 booklet *Allowance for Loan and Lease Losses*. Banking Circular 201 (Rev.), *Allowance for Loan and Lease Losses*, has been rescinded because the information contained in that circular has been incorporated into this booklet. The OCC booklet also incorporates a discussion of FASB Statement No. 114. The OCC booklet discusses the responsibility of a national bank's management to:

a. Have a program to establish and regularly review the appropriateness in accordance with GAAP of its allowance;

b. Implement an effective internal process that will ensure maintenance of an allowance appropriate in accordance with GAAP;

c. Maintain effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner;

d. Maintain the allowance at a level that is appropriate in accordance with GAAP to absorb all estimated inherent losses in the loan and lease portfolio at its evaluation date; and

e. Document its evaluation process sufficiently to establish the methods used and the factors considered by the bank provide a satisfactory basis for determining a level for the allowance that is appropriate in accordance with GAAP.

Practitioners serving national banks should be familiar with the OCC booklet.

9.22 Practitioners should also be familiar with the Federal Deposit Insurance Corporation's May 7, 1991, memorandum, *Allowance for Loan and Lease*

Losses, which provides guidance to agency examiners on assessing the appropriateness in accordance with GAAP of loan loss allowances and discusses related accounting literature. The memorandum also helps examiners highlight differences between regulatory and institution allowance rationales.

9.23 As discussed in paragraph 9.92, independent accountants should be skeptical if differences exist between the amounts of loan loss allowances estimated by management for regulatory purposes and for reporting in conformity with GAAP and should be prepared to justify such differences based on the circumstances.

9.24 Other guidance was provided to examiners in the agencies' December 6, 2006 joint issuance, in which they clarified final guidance on concentrations in commercial real estate lending. The guidance is intended to help ensure that institutions pursuing a significant commercial real estate lending strategy remain profitable while continuing to serve the credit needs of their communities. Other matters addressed include:

- Small to medium sized banks facing strong competition should be aware of the risk of unanticipated earnings and capital volatility due to increased real estate loan concentrations. The agencies provide supervisory criteria including the use of numerical indicators in identifying institutions with potentially significant CRE loan concentrations that may warrant greater supervisory scrutiny.
- The guidance also serves to remind institutions that strong risk management practices and appropriate levels of capital are important elements of a sound lending program, particularly when an institution has a concentration in commercial real estate loans.

9.25 Management is required to provide independent accountants with regulatory examination reports, which generally disclose classified loans and certain statistics regarding those classifications. If a regulatory examination is in process, the independent accountant should discuss the status and preliminary findings of the examination with institution management and the examiners. (Communications with regulators are discussed further in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters.")

9.26 The agencies established a policy on loan documentation effective March 30, 1993, to encourage lending to small and medium-sized businesses. The policy allows certain banks and savings institutions to establish a portfolio of loans exempt from certain documentation requirements. Examiners may not criticize the credit quality of an exempt loan on the basis of documentation and may not classify the loan unless it is delinquent by more than 60 days. The institution's management, however, is still required to fully evaluate the collectibility of exempt loans in determining the appropriateness in accordance with GAAP of loan loss allowances. (See paragraph 9.76.)

Credit Unions

9.27 Federal credit unions are required by part 702 of the National Credit Union Administration (NCUA) *Rules and Regulations* to establish and maintain an allowance for loan losses. Federally insured state-chartered credit unions are usually required by their insurance agreement with the National Credit Union Share Insurance Fund to establish and maintain an allowance. The requirements for state-chartered credit unions that are not federally insured vary by state and insurer.

9.28 Credit unions should not base the justification of a lower allowance for loan losses on the maintenance of the regular reserve. Regulators have historically stated that the regular reserve has been established to cover loan losses. Although this may be true in a regulatory sense, the regular reserve constitutes an appropriation of undivided earnings and should not be considered in determining the amount of the allowance for loan losses.

9.29 Some credit unions record a provision for loan losses equal to what would normally be transferred to the regular reserve from undivided earnings. Since the regular reserve may be reduced by the amount equal to the provision made, no regular reserve transfer is effectively made. The consequences of these actions may result in an overstatement of the allowance account. A credit union's allowance may be materially overstated due to strict adherence to this process.

9.30 For regulatory purposes, credit unions have historically used either the experience method or the adjustment method to calculate their allowance for loan losses. The NCUA has issued Accounting Bulletin No. 92-1, which provides guidance to credit unions for establishing and maintaining the allowance for loan losses, Interpretive Ruling and Policy Statement (IRPS) 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions*, and Letter No. 03-CU-01, *Loan Charge-Off Guidance*. Although the application of the NCUA's methods may or may not result in substantially the same allowance as management's estimate for the allowance, management should report an allowance in the financial statements prepared under GAAP that is appropriate in accordance with GAAP to cover all estimated losses incurred at the statement-of-financial-condition date in the loan portfolio.

9.31 For regulatory purposes, the NCUA issued Accounting Bulletin No. 06-01 in December 2006. The purpose of the bulletin is to distribute an advisory that addresses allowance for loan and lease losses (ALLL). It serves to reiterate key concepts and principles included in generally accepted accounting principles (GAAP), as well as previous ALLL supervisory guidance. The advisory is designed to supplement Interpretative Ruling and Policy Statement 02-03, Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions (NCUA's 2002 IRPS), and Update on Accounting for Loan Lease Losses (NCUA, and banking agencies).

Accounting and Financial Reporting

9.32 FASB Statement No. 114, as amended, and FASB Statement No. 5, *Accounting for Contingencies*, are the primary sources of guidance on accounting for the allowance for loan losses.[2] In addition, the banking agencies and the Securities and Exchange Commission (SEC) have issued three interagency statements on the allowance (November 1998, March 1999, and July 1999), which remind depository institutions of the requirement to record and report their allowance for loan and lease losses in accordance with GAAP. Moreover, the SEC staff had issued SAB No. 102, which expresses certain of the staff's views on the development, documentation, and application of a systematic methodology as required by Financial Reporting Release No. 28 for determining

[2] EITF Topic D-80, "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio," may provide additional guidance.

allowances for loan and lease losses in accordance with GAAP. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses.[3]

9.33 FASB Statement No. 5 is the primary guidance on the accounting and reporting of loss contingencies, including credit losses.[4] It requires that a creditor evaluate the collectibility of both the contractual interest and principal of all receivables when assessing the need for a loss accrual. FASB Statement No. 5 requires that an estimated loss from a loss contingency should be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

9.34 FASB Statement No. 5 states that if a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset (whether related to contractual principal or interest) can range from remote to probable. *Probable* means the future event or events are likely to occur; however, the conditions for accrual are not intended to be so rigid that they require virtual certainty before a loss is accrued. The conditions may be considered in relation to individual loans or groups of loans. However, if the conditions are met, a loss should be recognized even though the particular loans that are uncollectible may not be identifiable, such as large groups of loans for which credit losses have been incurred but which have not been associated with specific loans.

9.35 In estimating the amount of losses to be recognized under FASB Statement No. 5, institutions focus on the appropriateness in accordance with GAAP of the allowance for loan losses at each reporting date. The allowance for loan losses should be appropriate in accordance with GAAP to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio. Credit losses related to off-balance-sheet instruments should also be accrued and reported separately as liabilities if the conditions of FASB Statement No. 5 are met.[5] FASB Statement No. 114 amended FASB Statement No. 5 to clarify that a creditor should evaluate the collectibility of both the contractual interest and contractual principal

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[3] The FASB Staff issued a Viewpoints article in April 1999 providing additional guidance on accounting for loan losses.

[4] Other examples of loss contingencies (provided in paragraph 4 of FASB Statement No. 5) include—

Collectibility of receivables other than loans.

Guarantees of indebtedness of others.

Obligations of commercial banks under standby letters of credit.

Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

[5] Off-balance sheet financial instruments refers to off-balance sheet loan commitments, standby letters of credit financial guarantees, and other similar instruments with off-balance sheet credit risk except for those instruments within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. For such instruments within the scope of FASB Statement No. 133, credit exposure is captured by the fair value measurement required by the Statement. In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. For additional information regarding this amendment, see paragraphs 9.82 and 9.83.

of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*,[6] to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with FASB Statement No. 114. Provisions for loan and other credit losses should be charged to operating income sufficient to maintain the allowance for loan losses or liabilities related to off-balance-sheet credit losses at a level appropriate in accordance with GAAP—that is, management should address that the allowance is appropriate to cover incurred losses in accordance with GAAP of the allowance and the liabilities, not of the provision charged to income.

9.36 Credit losses for loans and trade receivables, which may be for all or part of a particular loan or trade receivable, should be deducted from the allowance. The related loan or trade receivable balance should be charged off in the period in which the loans or trade receivables are deemed uncollectible. Recoveries of loans and trade receivables previously charged off should be recorded when received.[7] An accrual for credit loss on a financial instrument with off-balance-sheet risk should be recorded separate from a valuation account related to a recognized financial instrument. Credit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which the liability is settled.[8]

9.37 FASB Statement No. 5 prohibits recognizing losses if the events causing the losses have not yet occurred. The act of lending money generally is not the event that causes asset impairment. Though some credit losses can be predicted, future losses should not be provided for at the time loans are made, because the events that cause the losses or loan impairment (for example, loss of employment, disability, or bankruptcy) have not yet occurred. Generally, a loan would be impaired at origination only if a faulty credit granting decision has been made or loan credit review procedures are inadequate or overly aggressive, in which case, the loss should be recognized at the date of loan origination.

9.38 FASB Statement No. 114 addresses the accounting by creditors for impairment of certain loans, uncollateralized as well as collateralized, except for (*a*) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, (*b*) loans that are measured at fair value or at the lower of cost or fair value, (*c*) leases (as defined in FASB Statement No. 13, *Accounting for Leases*), and (*d*) debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.[†] FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled*

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[6] The staff of the FASB issued FASB Staff Position (FSP) FAS 144-1, *Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15*, Accounting by Debtors and Creditors for Troubled Debt Restructurings, *and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets.

[7] AcSEC recognizes that practices differ between entities as some industries typically credit recoveries directly to earnings while financial institutions typically credit the allowance for loan losses for recoveries. AcSEC re-evaluated this practice as part of its deliberations on SOP 01-6. AcSEC decided not to amend this practice because the combination of this practice and the practice of frequently reviewing the adequacy of the allowance for loan losses results in the same credit to earnings in an indirect manner.

[8] See footnote 5.

[†] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, in Febuary 2007. The effective date of Statement No. 159 is November 15, 2007.

Debt Restructurings, as amended by FASB Statements No. 114 and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*,[9] established the accounting for troubled debt restructurings.

9.39 FASB Statement No. 114 requires that such impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral-dependent.[10] Paragraph 20 of FASB Statement No. 114, as amended, requires disclosure of information about loans that meet the definition of an impaired loan in paragraph 8 of the Statement. Included are various disclosures about the recorded investment in the impaired loans, the creditor's income recognition policy, restructured loans, and the activity in the allowance for loan losses.

9.40 SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*,[‡] addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. The SOP does not apply to loans originated by the entity or loans purchased that do not show evidence of credit quality problems. SOP 03-3 limits the yield that may be accreted (accretable yield) to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan. The SOP requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. SOP 03-3 prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment.

9.41 SOP 03-3 prohibits "carrying over" or creation of valuation allowances in the initial accounting of all loans acquired in a transfer that are within the scope of the SOP. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination. SOP 03-3 is effective for loans showing evidence of credit quality deterioration acquired in fiscal years beginning after December 15, 2004. Early adoption is encouraged. For problem loans acquired in fiscal years beginning on or before December 15, 2004, and within the scope of Practice Bulletin No. 6, paragraphs 7 and 8 of SOP 03-3, as they apply to decreases in cash flows expected to be collected, should be applied

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[9] See footnote 5.

[10] Paragraph 12 of FASB Statement No. 114 permits a creditor to aggregate impaired loans that have common risk characteristics and use historical statistics, such as average recovery period and average amount recovered, along with a composite interest rate as a means of measuring those impaired loans.

[‡] The AICPA has issued a Technical Practice Aid, *Application of SOP 03-3*, Accounting for Certain Loans or Debt Securities Acquired in a Transfer to Debt Securities. For additional information visit the AICPA Web site.

prospectively for fiscal years beginning after December 15, 2004. For additional discussion of SOP 03-3, see Chapter 8, "Loans."

9.42 SOP 01-6, paragraph 13*b*, states that, in addition to disclosures required by FASB Statements No. 5, No. 114, and No. 118, a description of the accounting policies and methodology the entity used to estimate its allowance for loan losses, allowance for doubtful accounts, and any liability for off-balance-sheet credit losses and related charges for loan, trade receivable, or other credit losses should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments. Institutions should also disclose their policy for charging off uncollectible loans and trade receivables.[11]

9.43 *Credit Unions.* A change from a method of calculating the allowance for loan losses that is not generally accepted (for example, a calculation used for regulatory purposes) to a method that is generally accepted and that results in an adjustment to the amount previously reported is considered a correction of an error and should be reported as a prior-period adjustment in accordance with paragraphs 25 and 26 of FASB Statement No 154, *Accounting Changes and Error Corrections—a replacement of APB No. 20 and FASB Statement No.3*. Such a change frequently arises when a credit union that has in the past undergone only supervisory committee audits initially undergoes an audit in accordance with generally accepted auditing standards (GAAS).

Auditing

Objectives

9.44 The primary objectives of audit procedures for credit losses are to obtain reasonable assurance that:

a. The allowances for loan losses and liability for other credit exposures are accurate and appropriate in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio at the balance-sheet date.

b. Allowances are not excessive, inasmuch as the loan portfolio should be reflected at net realizable value.

c. Credit losses and other items charged or credited to the allowance for loan losses, such as loan chargeoffs and recoveries, have been included in the financial statements at appropriate amounts.

d. Disclosures are adequate.

The independent accountant attempts to achieve those objectives by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The independent accountant is not responsible for estimating the amount of the allowance or ascertaining the

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[11] The FASB recently posted FSP No. 94-6-1, *Terms of Loan Products that May Give Rise to a Concentration of Credit Risk*. The proposed FSP outlines lending products that may give rise to increased credit risks, as well as the establishment of an allowance for loan losses, under FASB Statements No. 5, *Accounting for Contingencies* and No. 114, *Accounting by Creditors for Impairment of a Loan*.

collectibility of each, or any, specific loan included in an institution's loan portfolio.

Planning

9.45 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements, which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to credit losses. Because of the significance of loans to institutions' balance sheets, and because the estimation of loan losses is based on subjective judgments, independent accountants should assess inherent risk related to the allowance for loan losses as high. Such assessment should influence engagement staffing, extent of supervision, overall scope and strategy, and degree of professional skepticism applied. Further, independent accountants should be familiar with the applicable regulatory guidance, including guidance on the classification of credits, concentration of credits, foreign loans, and significant related parties. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance to auditors in obtaining and evaluating sufficient competent audit evidence to test significant accounting estimates in an audit of financial statements.

9.46 When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB Standards, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

9.47 The audit procedures performed in connection with the allowance for loan losses typically are time-consuming and are most efficient if initiated early in the audit. Because of the subjective nature of the loan review process, experienced audit personnel, preferably with prior depository institution engagement experience and, if necessary, with knowledge of industries in which the institution's loans are concentrated, should closely supervise or perform this section of the engagement. The assigned audit staff should also understand the lending environment, including credit strategy; credit risk; and the lending policies, procedures, and control environment of the institution, and should be familiar with known related parties and related-party transactions.

9.48 An important consideration in obtaining an understanding of the entity and its environment is whether an institution's internal loan review and internal audit functions can be considered by the independent accountant, and permit the independent accountant to modify the nature, timing, and extent of procedures to be performed. Discussions with internal loan review and internal audit staff can provide the independent accountant with information concerning loan customers, related-party transactions, and account histories that may not be readily available elsewhere. Also, because the internal audit department is involved in evaluating accounting systems and control activities (as discussed in Chapter 8, "Loans"), it can provide the independent accountant with important control process descriptions and results of testing that are helpful in understanding internal control. Chapter 5 discusses consideration of the internal audit function.

9.49 In determining the nature, timing, and extent of audit procedures, the independent accountant should assess the risk of material misstatement and consider factors such as:

- Composition of the loan portfolio
- Identified potential problem loans, including loans classified by regulatory agencies
- Trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies and restructured loans
- Previous loss and recovery experience, including timeliness of chargeoffs
- Concentrations of loans to individuals and their related interests, industries, and geographic regions
- Size of individual credit exposures (few, large loans versus numerous, small loans)
- Quality of internal loan review and internal audit functions, and results of their work
- Total amount of loans and problem loans, including delinquent loans, by officer
- Lending, chargeoff, collection, and recovery policies and procedures
- Local, national, and international economic and environmental conditions
- Experience, competence, and depth of lending management and staff
- Results of regulatory examinations
- Related-party lending

Internal Control Over Financial Reporting and Possible Tests of Controls

9.50 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314 requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities,[||] information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine

[||] For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

9.51 Effective internal control related to estimating the allowance for loan losses should reduce the likelihood of material misstatement of the allowance for loan losses. The independent accountant should obtain an understanding of how management developed the allowance for loan losses, how the process has changed from prior periods, and an understanding of the institution's loan portfolio, lending process, loan accounting policies, market focus, trade area, and other relevant factors. Specific aspects of effective internal control related to the allowance for loan losses should include the following:

- *Management communication of the need for proper reporting of the allowance.* The control environment strongly influences the effectiveness of the system of controls and affects the independent accountant's assessment of control risk. The control environment reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control. The independent accountant should consider:
  - — The level of integrity and ethical values
  - — The commitment to competence
  - — The level of involvement and quality of leadership provided by the board of directors, audit committee, and senior management in evaluating the allowance
  - — Management's philosophy and operating style
  - — The organizational structure
  - — The assignment of authority and responsibility
  - — Human resource policies and practices
- *Accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance.* Management reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. The institution's procedures and controls are important for identifying when loans should be placed on nonaccrual status, reserved for, or charged off. Most institutions have written policies covering nonaccrual status, the timing of chargeoffs, and transfers of loans to the special asset or workout department. Most institutions have policies and procedures for the gathering and analysis of information from and about debtors.
- *Independent loan review.* Loan reviews should be conducted by competent institution personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution. The loan review function should monitor and test line management's identification and evaluation of

existing and potential problem loans in a timely manner. The selection of loans for review should be representative and unbiased except for a bias toward higher risk loans.

- *Loss estimation process.* A loss estimation process for individually impaired loans and groups of other loans. This includes:
    - — Assigning responsibility for identification of impaired loans
    - — Assigning responsibility for measurement of impairment
    - — Impaired loan tracking and impairment measurement information system
    - — Historical loss tracking and loss rates measurement information system
    - — A process for documenting current economic conditions that differ from historical loss rates and justification for specific adjustments to historical loss averages
    - — A process for accumulating the component needs of the allowance and provision amounts
- *Adequate review and approval of the allowance estimates by the individuals specified in management's written policy*. This includes:
    - — Review of sources of relevant information
    - — Review of development of assumptions and methodologies
    - — Review of reasonableness of assumptions, methodologies, and resulting estimates
    - — Consideration of the need to use the work of specialists (such as appraisers or construction specialists)
    - — Consideration of changes in previously established methods to arrive at the allowance
- Comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance.

9.52 Because compliance with a well-defined lending policy is essential to an institution's asset quality, failure to follow that policy could have a substantial impact on the reliability of financial statement assertions. For example, authority limits established in management's written underwriting policies are based in large part on (*a*) the knowledge and skill of the reviewing loan officer or committee and (*b*) the credit risk the institution is willing to assume on a particular type of loan. A loan made for an amount in excess of an officer's limit, or for an unauthorized loan type, would normally involve greater amounts of credit or other risks. Accordingly, management's financial statement assertions about impairment and valuation of the loan portfolio, for example, may be affected.

9.53 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. The independent accountant may consider performing the following tests to test the effectiveness of internal controls over financial reporting in the area of credit losses:

- Review the company's accounting policies and procedures describing the process for determining, evaluating, and maintaining the allowance for loan losses and other credit losses in accordance with GAAP. Discuss these policies and procedures with appropriate personnel to determine whether they understand the related financial reporting objective.
- Review evidence that the company has procedures for identifying and reporting potential problem loans (e.g., a *watch list*) and following up on such loans, as well as delinquent loan reports and procedures for follow-up on delinquencies.
- Examine evidence that credit officers perform a periodic review of potential problem loans and assign risk ratings that are promptly reflected in a classified loan or other appropriate report.
- Examine evidence that senior management and appropriate board committee review and monitor past due, watch list, classified loans, and assigned risk ratings.
- Test the controls over the preparation of the periodic past due, watch list, and classified loans reports.
- Evaluate the basis for which each report is prepared, including which loans are included and excluded.
- Examine evidence that the delinquent loan report interfaces appropriately with the watch list or problem loan report.
- Test the reports' accuracy by tracing a sample of loans between the trial balance and the applicable report.
- Examine evidence that the company has a independent loan review function to review and evaluate credit officer's analysis of significant loans.
- Evaluate whether the results of loan confirmations support the integrity of loan trial balances, loan files, and delinquency reports.
- Review the company's documentation that analyzes the need for and documents each component of the allowance for credit losses. (For example, test the calculation of historical loss experience for one or more periods and one or more pools of loans, or test the calculation of discounted expected cash flow for one or more impaired loans.)
- Read minutes of meetings of the board or loan committee for evidence of board's periodic review and approval of the appropriateness in accordance with GAAP of the allowance for credit losses based on an appropriate documentation.

9.54 Audits performed in accordance with PCAOB Standards.[#] Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts

[#] In December 2006, the PCAOB proposed Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*, and Related Other Proposals, that would supersede AS2 and all other previous PCAOB guidance related to that standard. See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standards.

and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 (AICPA, *Professional Standards*, vol. 1) for a discussion on the extent of test of controls. Also, refer to Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing.

Substantive Tests

9.55 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to credit losses.

9.56 In evaluating the reasonableness of the allowance for loan losses, the independent accountant would concentrate on key factors and assumptions that are:

a. Significant to the estimate of the amount of the allowance, such as:

- The effectiveness of the institution's internal control related to loans and the allowance for loan losses
- Current local, national, and international economic conditions and trends, particularly as they have affected collateral values
- The amount of recoveries of loans previously charged off
- Composition of the loan portfolio and trends in volume and terms of loans, as well as trends in delinquent and nonaccrual loans that could indicate historical loss averages do not reflect current conditions
- Identified potential problem loans and large groups of problem loans, including delinquent and nonaccrual loans and loans classified according to regulatory guidelines
- Concentrations of loans to individuals or entities and their related interests, to industries, and in geographic regions
- Size of specific credit exposures (a few large loans versus numerous small loans)
- Quality of the internal loan review and internal audit functions
- The affects of changes in lending policies and procedures, including those for underwriting, credit monitoring, collection, and chargeoffs that could indicate historical loss averages do not reflect current conditions
- Results of regulatory examinations
- Nature and extent of related-party lending

b. Sensitive to variations (Assumptions based on historical trends, such as the amount of late or partial payments in a particular period and the amount of chargeoffs, can have a significant effect on estimates of the allowance.)

c. Subjective and susceptible to misstatement and bias, such as:

- The risk classification and allowance allocation given to problem loans
- Estimates of collateral values, and the related assumptions that drive the determination of such values, such as cash flow estimates, discount rates, and projected occupancy rates
- Current economic or market conditions that in the future may affect a borrower's ability to meet scheduled repayments
- Contingencies, such as a commitment for funding from a third party

9.57 The independent accountant should consider the historical experience of the institution in evaluating the appropriateness in accordance with GAAP of the allowance, as well as the independent accountant's experience with the industry. Changes in facts, circumstances, or an institution's procedures may cause factors different from those considered in the past to become significant to the estimate of the allowance at the balance sheet date.

9.58 Further, the independent accountant should consider the total credit exposure of particular borrowers, including that related to standby letters of credit, guarantees, commitments to lend, and other off-balance-sheet exposures in addition to the institution's liability for other credit exposures.

9.59 In performing substantive procedures, the independent accountant should consider the following approaches:

a. Review and test the process used by management to develop the allowance.

b. Develop an independent expectation of the allowance to corroborate the reasonableness of the allowance.

c. Review subsequent events and transactions occurring prior to completion of fieldwork.

9.60 In a number of situations, the audit strategy will include aspects of all three approaches. The independent accountant assesses reasonableness by performing procedures to test the process used by management to estimate the allowance. The following are procedures the independent accountant should consider:

- Identify whether there are controls over the preparation of the estimate of the allowance for loan losses and over the related supporting data that may be useful in the evaluation of the appropriateness in accordance with GAAP of the allowance and test controls.
- Identify the sources of data and other factors that management used in forming the assumptions and, based on information gathered in other audit tests, consider whether such data and factors are relevant, reliable, and sufficient for determining the allowance.
- Consider whether there are additional key factors or alternative assumptions about the factors.

- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether such data are sufficiently reliable for determining the allowance.
- Compare current-year chargeoffs with prior-period estimated losses to determine the historical reliability of prior-period estimates.
- Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- Review available documentation of the assumptions used in developing the allowance and inquire about any other plans, goals, and objectives of the institution, and consider their relationship to the assumptions.
- Test the calculations used by management to translate the assumptions and key factors into the estimate of the allowance for loan losses.
- Consider using the work of a specialist regarding certain assumptions.

9.61 The independent accountant should also test management's identification of loans that contain high credit risk or other significant exposures and concentrations. Sources of information the independent accountant should consider include:

- Recent regulatory examination reports
- Various internally generated listings, such as watch-list loans, past-due loans, loans on nonaccrual and restructured status, loans to insiders (including directors and officers), and overdrafts
- Management reports of total loan amounts by borrower
- Reports of historical loss experience by type of loan or risk rating
- Internal loan review reports on their review of loan files, which should identify whether they are lacking current financial data of borrowers and guarantors or current appraisals and may identify loans that are frequently rolled over
- Loan-documentation and compliance exception reports
- Loan committee minutes
- Inquiries of management regarding the experience and degree of turnover of loan officers
- Reports of the independent loan review function or internal audit
- Written lending policies, especially any recent policy changes

- Reports containing loans with repayment terms structured and restructured such that collectibility problems and concerns may not be evident until payments come due, such as construction loans with interest included in the loan commitment amount

9.62 These documents and other sources may identify:

a. Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions

b. Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value

c. Loans to borrowers in industries experiencing economic instability

d. Loan-documentation and compliance exceptions

9.63 It should be noted that, to the extent that such information is found in reports prepared by management and is to be relied on in substantive tests, the accuracy and completeness of such information should be evaluated by, for example, testing loan subsidiary ledgers and tracing delinquencies to the past-due reports.

9.64 AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance concerning the independent accountant's decision to use the work of a specialist. To properly evaluate the collectibility of certain loans, the independent accountant may need information outside of his or her usual experience. For example, the independent accountant might encounter valuation problems that require special knowledge of types of collateral. Factors to be considered in selecting a specialist include professional recognition of the specialist's competence in his or her field, reputation among peers, and relationship with the client.

9.65 For example, the knowledge of a specialist could be useful for loans based on oil and gas reserves. The specialist might review engineering reports on current reserves and production reports if the wells are in production. If fluctuating market conditions exist, a specialist could answer additional inquiries concerning the current status of oil and gas properties. For example, a loan secured by drilling equipment might have only marginal collateral value in a period of declining petroleum prices, even though the loan was highly secured when it was made.

9.66 Loans to developing countries are another example of instances in which the independent accountant may require the assistance of a specialist to become familiar with the economic, political, and social factors affecting the country's debt repayment. Other sources of such information include International Monetary Fund publications, international economists, and reports provided to institutions by the ICERC.

9.67 Engaging an appraiser, especially for real estate and other subjectively valued collateral, is another example of using a specialist. The independent accountant should be familiar with the basic concepts involved in the appraisal process in order to evaluate the competency and qualifications of appraisers. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information*, specifically addresses the understanding of the real estate appraisal process and the independent accountant's use of real estate appraisal information.

9.68 If the independent accountant finds that the appraisal or valuation information is deficient, the independent accountant should request that management secure additional information. Also, the independent accountant might consider selecting and hiring the appraiser or consultant directly.

9.69 ***Testing of Source Documents.*** The independent accountant should consider performing tests to determine that the loans are categorized in accordance with the objectives established and classified in accordance with the institution's loan review system. Detailed testing should focus on documents that are relevant to the institution's methodology.

9.70 ***Large Groups of Loans.*** For loans that are pooled for purposes of determining the allowance for loan losses, the focus of testing is not on individual loan files, and the collectibility of individual loans is generally not tested directly. Rather, the independent accountant generally reviews and tests for compliance with the institution's chargeoff and nonaccrual policy and tests the completeness and accuracy of historical data and reports, such as delinquency reports, that are relied upon in estimating the allowance for such loans.

9.71 For example, loan categories represented by large volumes of relatively small loans with similar characteristics, such as residential real estate mortgages, consumer loans, and credit-card loans, are generally evaluated on an aggregate, or pool, basis. The independent accountant is generally more concerned with the effectiveness of and adherence to procedures related to valuing such loans than with a critical appraisal of each individual loan. The testing or procedures and the review of delinquency status reports should permit the independent accountant to draw a conclusion about the appropriateness in accordance with GAAP of the allowance required for those loan categories. In evaluating the appropriateness in accordance with GAAP of the portion of the allowance attributable to those loans, use of unadjusted historical annual chargeoff experience may not be sufficient in itself but should be considered in light of consistent application of loan policies, and current and anticipated economic conditions based on facts in evidence at the balance-sheet date.

9.72 ***Individual Loan Review.*** Although the independent accountant's primary responsibility when reviewing the allowance for loan losses is the evaluation of its appropriateness in accordance with GAAP as a whole, practical considerations may dictate that the review be directed to the separate categories of loans that constitute the institution's portfolio. Because the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews also can be expected to vary.

9.73 Conversely, an evaluation of commercial loans generally requires a more detailed review, because the amount of an individual loan is generally large and the type of borrower, the purpose of the loan, and the timing of cash flows may be dissimilar. More important, a relatively small number of potential losses can significantly affect the appropriateness in accordance with GAAP of the allowance. In these circumstances, the independent accountant may select and review in detail a number of problem loans.

9.74 In addition to identified problem loans, the independent accountant may select other commercial loans to include in the detailed loan file review. The selection of these additional loans generally includes a stratum of large loan balances above specified limits, loans from other sources (such as related parties and industry concentrations), and some loans selected without regard to size or other specific criteria. The independent accountant generally will be concerned with the total credit exposure of the borrower, including standby letters of credit and other commitments to lend, rather than with individual loan balances. Based on the independent accountant's evaluations and tests, the number of loans reviewed might be limited when the internal loan review function is deemed appropriate in accordance with GAAP in identifying and classifying problem credits.

9.75 The extent of an individual loan review varies from loan to loan. For example, a loan that has been subjected to a recent management review, an effective internal review, or a recent regulatory review may be reviewed in less detail than a loan that has not had some or all of those reviews.

9.76 An institution's exempt portfolio could be material to its financial statements. The exemption of certain loans from examiner review and criticism pursuant to the March 30, 1993, regulatory policy (see paragraph 9.26) does not extend to management's financial reporting responsibilities or to the independent accountant's responsibility in financial statement audits or other engagements involving management assertions about the exempt loans. An independent accountant's assessment of management assertions about the allowance for credit losses may depend on the availability of certain documentation, including adequate collateral appraisals or current and complete financial information about borrowers or guarantors. The March 1993 policy may affect the availability of such documentation. Independent accountants are cautioned against undue reliance on management representations when no supporting evidence exists.

9.77 For each loan selected for review, the independent accountant may prepare a loan review worksheet or other memoranda documenting the procedures performed and summarizing the conclusions reached. Exhibit 9-2, "Sample Loan Review Form," is an example of a loan review form that could be used for a commercial loan. It can also be adapted to other types of loans. For loans reviewed previously, the independent accountant typically updates prior reviews for new information concerning the loan. In addition, the independent accountant usually reviews correspondence updating classified loans, working papers prepared by the institution's internal loan review personnel, and any regulatory examiner reports (including those with information on shared national credits). Such data often provide additional information concerning the loan and how management considered the loan in determining the allowance for loan losses.

Exhibit 9-2

Sample Loan Review Form

Client: ____

Audit Date: ____

Borrower's Name: ____

Nature of Business: ____

Purpose of Loan: ____

I. Borrower's Notes

Description	*Effective Interest Rate*	*Direct Loan or Participation*	*Line of Credit / Commitment Amount*	*Outstandings* *Principal*	*Outstandings* *Interest*
				_____	_____
Total loans outstanding at preliminary			__/__/__	=====	=====
Total loans outstanding at year-end			__/__/__	=====	=====

Accrual basis (Y/N) _______________

Repayment Schedule: ______________________________

Indicate probable repayment schedule if different from contractual schedule.

Approach used to estimate impairment (check one):

___Present value of cash flows

___Fair value of collateral

___Market value of loan

Repayment Status:______________________________

	Principal	*Interest*
Amount past due	=====	=====
Last payment:		
Date	_______	_______
Amount	_______	_______

(continued)

II. Contingencies/Guarantees (e.g., letters of credit, participations sold with recourse)

Total at preliminary ______

Total at year-end ______

III. Related Loans

Obligor	*Relationship*	*Maturity Date*	*Commitment Amount*	*Outstandings*
	Total Related Loans			______

IV. Collateral Summary

Description	*Gross Value*	*Prior Liens*	*Value to Lender*	*Basis for and Date of Valuation (e.g., appraisal, market value quotes)*
Total	______	______	______	______

V. Guarantors

VI. Loan Grade

Regulatory Classification	*Amount*	*Institution's In-House Classification*	*Amount*
Special mention			
Substandard			
Doubtful			
Loss			
Unclassified			
Total	______		______

Is the loan impaired not defined in FASB Statement No. 114 (Y/N)? ______

(continued)

VII. Financial Data

Auditors:____

Type of opinion: ______________________ Last audit date: _________________________

	Interim		*Fiscal Year*	
	Current-Year __months ended / /	*Prior-Year __months ended* / /	*Current Year* / /	*Prior Year* / /
Current assets	_______	_______	_______	_______
Current liabilities	_______	_______	_______	_______
Working capital	_______	_______	_______	_______
Total assets	_______	_______	_______	_______
Total liabilities	_______	_______	_______	_______
Net worth	═══════	═══════	═══════	═══════
Net sales	_______	_______	_______	_______
Net income	_______	_______	_______	_______
Cash flow	_______	_______	_______	_______

VIII. Loan Officer ____

Comments

Provide a narrative analysis prepared by [*or through inquiry of*] the loan officer of collectibility including estimated repayment dates, sources of repayment, appropriateness in accordance with GAAP of collateral to cover outstanding principal and interest, financial data on guarantors, and rationale for any estimated allowance allocation, chargeoff, or both.

____

Institution's estimated specific allowance allocation, chargeoff, or both and management's supporting rationale:

____

IX. Independent Accountant's Summary __________________________

X. Conclusion (including the amount and basis for independent accountant's estimated loss exposure)____________________________________

____

9.78 For many loans, the independent accountant should discuss the status and background of the loans reviewed with the responsible loan officer and the loan review officer. In addition to providing information about the loans, such discussions may provide the independent accountant with information about the loan officer's and loan review officer's attitudes and degree of awareness of the status of loans and internal controls.

9.79 In reviewing individual loans, the independent accountant should review the institution's analysis of the borrower's financial resources, liquidity and future cash flows, and other financial forecasts, particularly for unsecured loans for which repayment is dependent on the borrower's ability to generate funds from profitable operations. The independent accountant should consider measuring such financial data against the trends and norms, both historical and forecasted, for both the borrower being reviewed and the industry in which the borrower operates. It is preferable that the institution's analysis be supported by current audited financial statements, although financial statements that have been reviewed or compiled by the borrower's independent accountant or prepared internally by the borrower may be useful.

9.80 If the independent accountant deems the financial information inadequate, the independent accountant should discuss the situation with an appropriate member of management. The discussion may include missing information which can be a control issue as well. The results of such discussion or the inability of the institution to obtain financial information that is appropriate in accordance with GAAP should be considered in evaluating the collectibility of the loan. If financial information that is appropriate in accordance with GAAP is not available for significant loans, the independent accountant should notify management that a scope limitation may result.

9.81 For loans secured by collateral, a careful evaluation and valuation of that collateral is often necessary. In such circumstances, the independent accountant should evaluate the security interest in the collateral to determine how the institution knows that it has been perfected by execution and recording of the appropriate legal documents. The independent accountant should also review the reasonableness of the institution's collateral valuation by referring to quoted market prices or other pertinent sources, such as a specialist's appraisals or engineering reports.

9.82 The independent accountant may test the existence of the collateral by physical observation, independent confirmation, or other appropriate procedures, especially when the institution is involved in loans secured by marketable securities or in asset-based lending, which may include loans secured by inventories, equipment, or receivables. For collateral in the form of marketable securities, the independent accountant may evaluate whether such securities are under the institution's control, either in its own vault or in a safekeeping account in the institution's name maintained with an independent, third-party custodian. In the latter case, the independent accountant may wish to evaluate the independent custodian's ability to perform under its obligation. The AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions* discusses additional considerations applicable to loans collateralized with marketable securities. For other types of collateral, there should be documentation that the institution has verified the existence of the collateral. In the absence of such documentation, the independent accountant should perform these or other collateral verification procedures, especially for significant loans for which collectibility is otherwise questionable. The auditor should also consider the accounting consequence under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

9.83 For loans supported by personal guarantees, the independent accountant may perform a review solely of the borrower's ability to pay. However, if the review indicates the guarantor may be a source of repayment, the independent accountant should also review the financial statements and other pertinent information about the guarantor as if the guarantor were the borrower. It is also important to consider the extent of, as well as the institution's policies and practices for, pursuing guarantees and to evaluate, perhaps in consultation with an attorney, the enforceability and scope of the guarantee.

9.84 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement.

9.85 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. Paragraph 14 of FASB Statement No. 140 has been amended by FASB Statement No. 156. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

9.86 The substance of a guarantee depends on (*a*) the ability and willingness of the guarantor to perform under the guarantee, including a determination of whether the guarantor has other guarantees outstanding that might be pursued, (*b*) the practicality of enforcing the guarantee in the applicable jurisdiction, (*c*) the scope of the guarantee (that is, whether it covers all principal and interest or has a limit), and (*d*) a demonstrated intent by the institution to enforce the guarantee. Even if the guarantee is legally enforceable, the independent accountant should attempt to determine whether there are business reasons that might preclude the institution from enforcing the guarantee. Those business reasons could include the length of time required to enforce a guarantee, whether it is normal business practice to enforce guarantees on similar transactions, or whether the institution must choose between pursuing the guarantee or the underlying collateral, instead of pursuing both.

9.87 ***Participation and Purchased Loans.*** Management should have the information necessary to authorize, monitor, and review participation loans and to estimate any related allowance for loan losses. The collectibility of participation loans (whether at the lead institution or at a participating institution) is normally evaluated in light of the entire amount of the loan, not just of the share held by the institution. Accordingly, the participating institution should supplement documentation by the lead institution with its own investigation and credit analysis. The participating institution should not rely solely on the lead institution to monitor the credit. Certain large participation arrangements are reviewed by regulators, who issue a shared national credit report detailing their classification and rationale to the lead and all participating institutions. The independent accountant's objectives in testing loans for a participating institution is the same as for other loans. For example, the repayment status, borrowers' financial statements, and appraisals should be considered.

9.88 The independent accountant usually confirms the existence and terms of significant participations (both purchased and sold) with the debtor and lead institution. In addition, the independent accountant normally reviews the related loan file documentation. For participations, the loan files should contain the same information as other loan files.

9.89 ***Chargeoffs and Recoveries.*** The independent accountant should consider testing the propriety of chargeoffs and recoveries. Substantive detail testing in this area may be minimized if tests of controls and analytical procedures on chargeoffs and recoveries are performed.

9.90 ***Analytical Procedures.*** The independent accountant should perform overall analytical tests to supplement the detailed tests of the reasonableness of the allowance. These analytical tests may use statistics relating to the allowance as compared to related income statement accounts, net chargeoff rates, nonperforming loan levels and other loan categories, historical experience, and peer results. Various analytical techniques can be utilized to assist the independent accountant in determining the appropriateness in accordance with GAAP of the allowance. See Chapter 5 of this Guide for additional guidance regarding analytical procedures.

9.91 ***Conclusions.*** At the conclusion of the testing, the independent accountant should consider whether management's estimate of the allowance for loan losses is reasonable in relation to the financial statements taken as a whole. Because no one estimate of the allowance can be considered accurate with certainty, the independent accountant may, based on the testing performed and understanding of the facts and circumstances, determine a range for the allowance that is in accordance with GAAP considered reasonable. If management's estimate is within the reasonable range determined by the independent accountant, the independent accountant would be satisfied that the estimate of the allowance for loan losses is reasonable. However, the independent accountant should evaluate the allowance estimate for consistent placement within the range. If the institution's estimate is outside that reasonable range, the independent accountant should treat the difference between the institution's estimate and the closest reasonable estimate as a likely error and aggregate it with other likely errors, which the independent accountant must consider before reporting on the financial statements taken as a whole.

9.92 Furthermore, during their examinations of depository institutions, regulators focus a great deal of attention on the allowance for loan losses. Failure to maintain an adequate allowance is considered an unsafe or unsound practice. Due to the subjectivity involved in estimating the allowance, the allowance amounts determined to be appropriate in accordance with GAAP by management and the regulatory examiners may differ. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue No. 85-44, *Differences Between Loan Loss Allowances for GAAP and RAP*, that the amount of the allowance reported in an institution's financial statements may differ from the amount reported for regulatory purposes. However, the EITF warned that independent accountants should be particularly skeptical of such differences and must justify them based on the particular facts and circumstances.

Chapter 10

Transfers of Loans and Mortgage Banking Activities[*]

Introduction

10.01 Mortgage banking activities consist primarily of the purchase or origination of mortgage loans for sale to secondary market investors and the subsequent servicing of those loans. Mortgage loans can be grouped together and sold outright or pooled and securitized with or without a credit enhancement such as the guarantee of a federal agency or government-sponsored enterprise (GSE). This chapter discusses mortgage banking, as well as other sales or securitizations of loans.

10.02 Access to the secondary mortgage market is an important source of liquidity for banks and savings institutions. Many institutions have deposit bases that are keyed to variable rates and, therefore, are particularly sensitive to interest-rate risk. A variable-rate deposit base cannot fund long-term, fixed-rate assets without creating significant loss exposure in rising interest-rate environments. Therefore, sales of mortgage loans and servicing rights in the secondary market and the accompanying gains and losses and creation of income streams from servicing and other fees are an important source of funds to many institutions. Access to the secondary market also provides opportunities to restructure existing long-term portfolios.

10.03 The primary participants in the secondary market for residential financing are GSEs such as Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) and Federal National Mortgage Association (FNMA or Fannie Mae) and federal agencies such as Government National Mortgage Association (GNMA or Ginnie Mae) and the Department of Veterans' Affairs (VA). These entities participate in the secondary market as issuers, investors, or guarantors of asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), real estate mortgage investment conduits (REMICs), and collateralized mortgage obligations (CMOs). (Chapter 7, "Investments in Debt and Equity Securities," describes ABS transactions and considerations for investors in ABSs.) Many private entities are also active in the secondary market as issuers and investors.

10.04 When mortgage loans are originated for sale, the process includes not only finding an investor but also preparing the loan documents to fit the investor's requirements. Mortgage loans originated for sale normally must comply with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications. Investors will typically review underlying documentation prior to completing their purchase. Individual loans that fail to meet the specified criteria are eliminated from the pool of loans eligible for sale. If exceptions cannot be corrected, the selling institution may have to either find alternative investors or transfer the loan to the institution's portfolio. In most cases, the originating institution may be subject to recourse

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

by the investor for underwriting exceptions identified subsequent to the sale of the loans and any related defaults by borrowers.

10.05 The extent to which mortgage loans are originated for sale will differ for each institution. Factors such as liquidity, interest-rate exposure, asset/liability management policy, and capital considerations will influence the nature and extent of an institution's mortgage banking activities. One institution may manage its interest-rate risk position by intentionally selling all fixed-rate mortgage loans it originates, while another institution may originate a variety of both fixed- and variable-rate loan products for sale.

Asset-Backed Securitizations

10.06 Securitization is often utilized by lending institutions to diversify funding sources. In some markets, securitization has reduced entry barriers and increased competition. Securitization involves the sale, generally to a trust, of a portfolio of loan receivables. Asset-backed certificates are then sold by the trust to investors through a private placement or public offering. Typically, the company will retain the servicing rights for the loans sold to the trust. A subordinated interest in the trust is also typically retained by the company, serving as a credit enhancement to the asset-backed certificates. Such structures provide the opportunity for less credit-worthy companies to obtain funding at competitive levels through the asset-backed and other structural characteristics of securitization vehicles.

Loan Servicing

10.07 If mortgage or other loans are sold, the selling institution sometimes retains the right to service the loans for a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans, that is collected over the life of the loans as payments are received. A typical servicing agreement requires the servicer to carry out the servicing function, including billing and collection of borrowers' payments; remittance of payments to the investor, insurers, and taxing authorities; maintenance of custodial bank accounts; and related activities. The agreement also may involve significant risks being retained by the servicer such as allowing the investor recourse to collect certain credit losses from the servicer. Serviced loans may have been originated by the servicer institution itself or by other financial institutions. When servicing mortgages for service agents such as GNMA, FNMA, or FHLMC, institutions must meet certain minimum net-worth requirements. Inability to meet the requirements may result in termination of the service contracts.

Regulatory Matters

10.08 The federal banking agencies limit the aggregate amount of servicing assets, which includes mortgage servicing assets that may be included in regulatory capital.

10.09 On December 13, 1999, the federal banking agencies jointly issued the Interagency Guidelines on Asset Securitization that highlight the risks associated with asset securitization and emphasize the agencies' concerns with certain retained interests generated from the securitization and sale of assets. The guidelines set forth the supervisory expectation that the value of retained interests in securitizations must be supported by objectively verifiable documentation of the assets' fair-market value, utilizing reasonable, conservative valuation assumptions. Retained interests that do not meet such standards or that fail to meet the supervisory standards outlined in the guidance will be disallowed as assets of the bank for regulatory capital purposes. The guidance stresses the need for bank management to implement policies and procedures that include limits on the amount of retained interests that may be carried as a percentage of capital. Institutions that lack effective risk management programs or engage in practices deemed to present other safety and soundness concerns may be subject to more frequent supervisory review, limitations on retained interest holdings, more stringent capital requirements, or other supervisory response. The banking regulators have recently issued two interagency advisories, *Interagency Advisory on Mortgage Banking* and *Interagency Advisory on the Accounting Treatment of Accrued Interest Receivables Related to Credit Card Securitizations*. In May 2005, the OCC, FDIC, FRB, OTS and NCUA issued "Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans." This advisory provides guidance related to the origination of mortgage loans that will be held for resale, and the sale of mortgage loans under mandatory delivery and best efforts contracts.

10.10 On May 17, 2002, the banking regulators issued the *Interagency Advisory on Mortgage Banking* and *Interagency Advisory on the Accounting Treatment of Accrued Interest Receivables Related to Credit Card Securitizations*. This advisory clarified that Accrued Interest Receivable (AIR) represents a subordinated interest held by the transferor in cash flows of a credit card securitization, and that AIR meets the definition of a recourse exposure for risk-based capital purposes, and as such, requires a "dollar-for-dollar" capital.

10.11 On February 23, 2003, the banking regulators issued the *Interagency Advisory on Mortgage Banking*. This guidance focuses on risks associated with valuation and modeling processes, hedging activities, management information systems, and internal audit processes in connection with mortgage banking activities.

10.12 On May 3, 2005, the OCC, FDIC, FRB, OTS and NCUA issued "Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans." This advisory provides guidance related to the origination of mortgage loans that will be held for resale, and the sale of mortgage loans under mandatory delivery and best efforts contracts.

Accounting and Financial Reporting

Mortgage Loans and Mortgage-Backed Securities Held for Sale

10.13 FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, as amended, establishes the accounting for mortgage loans held for sale.

10.14 Paragraph 4 of FASB Statement No. 65, as amended, says that mortgage loans held for sale should be reported at the lower of cost or market value, determined as of the balance-sheet date. As amended by FASB Statement No. 133, *Accounting for Derivatives and Hedging activities paragraph 22(b)*, Statement No. 65, requires that if a mortgage loan has been the hedged item in a fair value hedge, the loan's "cost" basis used in lower-of-cost-or-market accounting shall reflect the effect of the adjustments of its carrying amount.[1,†]

10.15 Paragraph 4 of FASB Statement No. 65 requires that the amount by which the cost of such loans exceeds their market value should be accounted for as a valuation allowance. Paragraph 4 requires that changes in the valuation allowance should be included in the determination of net income of the period in which the change occurs.

10.16 Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 134, *Accounting for Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, requires that after the securitization of a mortgage loan held for sale, any retained MBSs shall be classified in accordance with the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.[2,‡] However, a mortgage banking enterprise must classify as trading any retained MBSs that it commits to sell before or during the securitization process.

10.17 Paragraph 6 of FASB Statement No. 65 requires that mortgage loans transferred from loans held for sale to long-term-investment classification should be valued at the lower of cost or market on the date of transfer.[||]

10.18 Paragraph 9 of FASB Statement No. 65 states that either the aggregate or individual loan basis may be used in determining the lower of cost or market value for each type of mortgage loan. Paragraph 9 of FASB Statement No. 65, as amended, states that the market value of committed mortgage loans and uncommitted mortgage loans should be determined separately as follows:

a. Committed loans should be valued based on fair values. The contractual service fee should be valued in accordance with FASB Statement No. 65.

b. Uncommitted loans should be valued based on the market in which the institution normally operates:

   (1) Market prices and yields sought by the mortgage banking enterprise's normal market outlets

   (2) Quoted Ginnie Mae security prices or other public market quotations for long-term mortgage loan rates

   (3) Freddie Mac and Fannie Mae current delivery prices

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[1] In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. For additional information see paragraph 10.21 and 10.22.

[†] The FASB recently issued Statement No. 157, *Fair Value Measurements*, which is effective for fiscal years beginning after November 15, 2007. The Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

[2] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in this FSP should be applied to reporting period beginning after December 15, 2005. In addition, the FASB has recently issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. The effective date for Statement No. 159 is November 15, 2007.

[‡] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The effective date is November 15, 2007. Entities may opt for early adoption of Statement 159, subject to conditions outlined in the Statement.

[||] See footnote at paragraph 10.14 for information on FASB Statement No. 157, *Fair Value Measurements*.

10.19 Paragraph 12 of FASB Statement No. 65 requires, in part, that the carrying amount of mortgage loans to be sold to an affiliated enterprise (as defined) should be adjusted to the lower of cost or market value[#] of the loans as of the date management decides that a sale to an affiliated enterprise will occur. Paragraph 13 of the Statement requires, in part, that, if a particular class of mortgage loans, or all loans are originated exclusively for an affiliated enterprise, the originator is acting as an agent of the affiliated enterprise, and the loan transfers should be accounted for at the originator's acquisition cost.

10.20 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of Statement 133 prior to the adoption of this Statement.

Transfers and Servicing of Loans

10.21 As discussed in Chapter 7, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,[**] provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. FASB Statement No. 115[3] addresses accounting for securities, including securitized loan pools. Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, paragraph 8*c* states:

> Once a decision has been made to sell loans not previously classified as held for sale, such loans should be transferred into the held-for-sale classification and carried at the lower of cost or fair value. [*footnote omitted*] At the time of the transfer into the held-for-sale classification, any amount by which cost exceeds fair value should be accounted for as a valuation allowance.

The following two paragraphs discuss whether the adjustments should be done by using an allowance method or as a direct write down, depending on the circumstances involved.

[#] The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, expected to be finalized in the first quarter of 2007. In November of 2005 the FASB staff issued FASB Staff Position (FSP) FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*. This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

[**] The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, expected to be finalized in the first quarter of 2007.

In November of 2005 the FASB staff issued FASB Staff Position (FSP) FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*. This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

[3] See footnote 2 in paragraph 10.16.

10.22 On March 26, 2001, the Federal Financial Institutions Examinations Council (FFIEC) issued guidance, *Interagency Guidance on Certain Loans Held for Sale*, to provide instruction to institutions and examiners about the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held for sale account. That guidance addresses transfers to the held-for-sale (HFS) account for loans within its scope and states:

> When a decision is made to sell a loan or portion thereof that was not originated or initially acquired with the intent to sell, the loan should be clearly identified and transferred to the HFS account. The transfer to the HFS account should be recorded at the lower of cost or fair value on the date the decision to sell is made.

That guidance also addresses accounting at transfer date for loans within its scope and states:

> At the time of a loan's transfer to the HFS account, any reduction in the loan's value should be reflected as a write-down of the recorded investment resulting in a new cost basis, with a corresponding reduction in the allowance for loan and lease losses (ALLL). To the extent that the loan's reduction in value has not already been provided for in the ALLL, an additional loan loss provision should be made to maintain the ALLL at an adequate level.

Accordingly, for institutions subject to the FFIEC guidance, once the decision has been made to sell loans not previously classified as held for sale, such loans should be transferred into the held for sale classification. For loans with declines in fair value that are attributable to credit quality, any reduction in the loan's value at the time of the transfer into the held-for-sale classification should be reflected as a write-down of the recorded investment resulting in a new cost basis, with a corresponding reduction in the ALLL. Thus, the FFIEC guidance adds to the provisions of a requirement to write down the transferred loan and establish a new cost basis for institutions subject to FFIEC guidance.

10.23 In contrast, for loans with declines in fair value that are attributable to interest or foreign exchange rates and clearly are not attributable, in any respect, to credit or transfer risk, any amount by which the recorded investment exceeds fair value at the time of the transfer into the held-for-sale classification should be accounted for as a valuation allowance.

10.24 Variable-rate loans are generally sold at stated rates, with gain or loss measurement based on a premium or discount on the face value of the portfolio to be sold. Fixed-rate loans are generally sold at a discount or premium to provide a specified yield to the investor, and the corresponding gain or loss is based on the difference between the yield of the loans to be sold and the contractual yield to the investor. The yield on a pool of loans is the calculated weighted-average interest rate for that pool.

Transfers of Loans With Recourse

10.25 Institutions may transfer loans with recourse. This may be accomplished to deliver loans into a particular investor's commitment program, to obtain a better price, or both. For example, a seller may be required to make full or partial payment to the purchaser if the debtor fails to pay when payment is due. Similarly, a seller may be required to make payments to the purchaser as the result of loan prepayments or because of adjustments resulting from defects (such as failure to perfect a security interest in collateral) of the transferred loans. In some cases (for example, student loans), underwriting exceptions identified subsequent to the transfer of loans may subject the seller to additional recourse risk if the borrower defaults on the loan. Because of the continuing risk of delinquency and foreclosure, the institution's management should carefully evaluate its potential contingent liabilities with respect to such loans. FASB Statement No. 140 provides guidance on accounting for transfers of loans with recourse. The recourse obligation should be recorded at fair value based on guidance in FASB Statement No. 140. Paragraph 11c of FASB Statement No. 140 states that upon completion of a transfer that satisfies the conditions to be accounted for as a sale, the transferor shall initially measure at fair value liabilities incurred in a sale.

Servicing Rights

10.26 Servicing rights are significant assets for some institutions. They have value in addition to the servicing fee value because of the servicer's ability to invest the "float" that results from payments that are received from borrowers but are not yet passed on to the investors in the loans. Additionally, intrinsic value components of servicing rights include ancillary income, such as late-payment charges and prepayment charges. Accordingly, servicing rights, either separately or as part of a loan, are generally readily purchased and sold.

10.27 In March of 2006 the FASB issued Statement of Financial *Accounting Standards No. 156, Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

10.28 ***Recognition and Measurement of Servicing Assets and Liabilities.*** Paragraph 13 of FASB Statement No. 140 as amended by FASB Statement No. 156 addresses the recognition and measurement of servicing assets and liabilities, including mortgage servicing rights. Paragraph 13 requires that each time an institution undertakes an obligation to service financial assets, it should recognize and initially measure at fair value, if practicable, either a servicing asset or a servicing liability in any of the following situations:

- A transfer of the servicer's financial assets that meets the requirements for sale accounting
- A transfer of the servicer's financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates
- An entity that transfers its financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as debt securities held-to-maturity in accordance with Statement 115 may either separately recognize its servicing assets or servicing

liabilities or report those servicing assets or servicing liabilities together with the asset being serviced

10.29 Paragraph 13A as amended by FASB Statement No. 156 states an entity shall subsequently measure each class of servicing assets and servicing liabilities using one of the following methods:

- The amortization method requires that a servicing asset or liability be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). The servicing asset or liability should be assessed for impairment or increased obligation based on its fair value at each reporting date.
- Fair value measurement method: Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value of servicing assets and servicing liabilities in earnings in the period in which the changes occur.

The election described in this paragraph shall be made separately for each class of servicing assets and servicing liabilities. An entity shall apply the same subsequent measurement method to each servicing asset and servicing liability in a class. Classes of servicing assets and servicing liabilities shall be identified based on (a) the availability of market inputs used in determining the fair value of servicing assets or servicing liabilities, (b) an entity's method for managing the risks of its servicing assets or servicing liabilities, or (c) both. Once an entity elects the fair value measurement method for a class of servicing assets and servicing liabilities, that election shall not be reversed (paragraph 63). If it is not practicable to initially measure a servicing asset or servicing liability at fair value, an entity shall initially recognize the servicing asset or servicing liability in accordance with paragraph 71 and shall include it in a class subsequently measured using the amortization method.

Paragraph 13B states that an entity shall report recognized servicing assets and servicing liabilities that are subsequently measured using the fair value measurement method in a manner that separates those carrying amounts on the face of the statement of financial position from the carrying amounts for separately recognized servicing assets and servicing liabilities that are subsequently measured using the amortization method. To accomplish that separate reporting, an entity may either (a) display separate line items for the amounts that are subsequently measured using the fair value measurement method and amounts that are subsequently measured using the amortization method or (b) present the aggregate of those amounts that are subsequently measured at fair value and those amounts that are subsequently measured using the amortization method (paragraph 63) and disclose parenthetically the amount that is subsequently measured at fair value that is included in the aggregate amount.

10.30 Paragraphs 61 through 67 of FASB Statement No. 140, as amended by FASB Statement No. 156, provide related guidance. Paragraph 63 of FASB Statement No. 140 specifies the accounting for a contract to service financial assets separately from those assets.

10.31 EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*, addresses whether certain provisions of agreements to sell mortgage servicing rights preclude the recognition of a sale at the date title passes, or whether the sale should be recognized at that date with accrual of any estimated liability. In Issue No. 95-5, the EITF reached a consensus that sales of rights to service mortgage loans should be recognized when the following conditions have been met (*a*) title has passed, (*b*) substantially all risks and rewards of ownership have irrevocably passed to the buyer and (*c*) any protection provisions retained by the seller are minor and can be reasonably estimated. If a sale is recognized and minor protection provisions exist, a liability should be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if (*a*) the obligation associated with those provisions is estimated to be no more than 10 percent of the sales price and (*b*) risk of prepayment is retained for no longer than 120 days.

10.32 The EITF Issue No. 95-5 carried forward from Issue No. 89-5, *Sale of Mortgage Loan Servicing Rights*, the consensus that a temporary subservicing agreement in which the subservicing will be performed by the seller for a short period of time would not necessarily preclude recognizing a sale at the closing date.[4]

10.33 SOP 01-6, paragraph 8*g*,[5] states that, criteria that should be considered when evaluating whether a transfer of servicing rights qualifies as a sale are the guidance, as applicable, in EITF Issue No. 95-5 and the following:

- Whether the seller has received written approval from the investor if required[6]
- Whether the buyer is a currently approved seller/servicer and is not at risk of losing approved status
- In the event of a sale in which the seller finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the buyer's commitment to pay the remaining sales price) and whether the note receivable from the buyer provides full recourse to the buyer (Nonrecourse notes or notes with limited recourse (such as to the servicing) do not satisfy this criterion.)
- Also, temporary servicing performed by the transferor for a short period of time should be compensated in accordance with a subservicing agreement that provides adequate compensation.

10.34 ***Sales of Servicing Rights.*** SOP 01-6, paragraph 8*h*, states that, sales of servicing rights relating to loans previously sold should be recognized in income subject to the considerations above. Sales of servicing rights relating to loans that are retained should also be recognized in income subject to the considerations above and at the date of sale, the carrying amount should be allocated between the servicing rights and loans retained using relative fair values

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[4] EITF Issue No. 95-5 also states that the consensus carried forward from EITF Issue No. 89-5 supersedes the consensuses reached by the EITF in Issue No. 89-5.

[5] EITF Issue No. 95-5 provides guidance for determining whether a transfer of servicing rights should be accounted for as a sale.

[6] Servicing rights may be purchased by brokers or investment bankers that intend to seek buyers for the rights. Although such purchases cannot be canceled, approval of the transfer of the rights is not requested by the seller until the broker enters into a transaction with the third-party purchaser. Thus, such transactions should generally be characterized as financing transactions and a sale has not occurred until an approval of transfer of rights has been requested, even though other contingencies are resolved.

as described in a manner consistent in paragraph 10(b) of FASB Statement No. 140 as amended by Statement 156.

10.35 In general, three to six months elapse between entry into a contract to sell servicing rights and actual delivery of the loan portfolio to be serviced. These delays may result from the purchaser's inability to accept immediate delivery, the seller's inability to immediately transfer the servicing records and loan files, difficulties in obtaining necessary investor approval, requirements to give advance notification to mortgagors, or other planning considerations. Issues relating to the transfer of risks and rewards between buyers and sellers of servicing rights may be complex.

10.36 EITF Issue No. 85-13, *Sale of Mortgage Service Rights on Mortgages Owned by Others*,[††] addresses whether (and how) gains should be recorded on such sales.

10.37 EITF Issues No. 87-34,[††] *Sale of Mortgage Servicing Rights With a Subservicing Agreement*, and No. 90-21,[††] *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights With a Subservicing Agreement*, provide additional guidance. Also, readers may refer to EITF Appendix D, Topics D-2 and D-39, which addresses mortgage banking and questions on FASB Statement No. 115,[7] respectively, issues that are relevant to this section's discussions.

VA No-Bids and Private Mortgage Agencies

10.38 Historically, the VA paid lenders 100 percent of the outstanding debt on defaulted loans that the VA guaranteed. In return, the lenders turned the borrowers' houses over to the VA, which would dispose of them. The VA has the option of guaranteeing the lesser of 60 percent of a loan's original balance or $27,500, leaving the property with the lender if that is less costly for the agency. Called a *no-bid option*, this practice was seldom used, especially because inflation pushed up housing prices during the late 1970s and early 1980s. However, as inflation began to slow and the costs of carrying foreclosed houses began to rise, the VA began to invoke the no-bid option. Institutions may incur losses due to the uncollectibility of receivables from other government programs such as the Federal Housing Administration (FHA) or Ginnie Mae, from other investors such as Freddie Mac and Fannie Mae, or from insolvent private mortgage insurers.

10.39 With the increased risk of foreclosure losses (including unrecoverable interest advances; foreclosure costs such as attorneys' fees, inspections, and so forth; and the implicit cost to carry the asset until ultimate sale), the evaluation of loss allowances on VA and privately insured mortgage loans has become increasingly difficult. Chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," provides guidance on the valuation of foreclosed real estate, and Chapter 9, "Credit Losses," provides guidance on the evaluation of the collectibility of real estate loans.

Financial Statement Presentation and Disclosure

10.40 Loans or trade receivables held for sale should be a separate balance-sheet category and should be reported at the lower of cost or market value.[8]

[††] This EITF Issue has been amended by the issuance of the FASB Statement No. 156. For additional information see paragraph 10.

[7] See footnote 2 in paragraph 10.16.

[8] See footnote 1.

Paragraph 9 of FASB Statement No. 65, as amended by FASB Statement No. 134 requires that after the securitization of a mortgage loan held for sale, any retained MBSs shall be classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained MBSs that it commits to sell before or during the securitization process. SOP 01-6, paragraph 13*d*, states that, the aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans held for sale at the lower of cost or fair value) should be presented separately in the financial statements or disclosed in the notes to the financial statements.[9] Per paragraph 9 of FASB Statement No. 102, *Statement of Cash Flows-Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Acquired for Resale*, net cash flows from purchases, originations, and sales of loans held for sale should be classified as operating cash flows. Net cash flows from sales of other loans should be classified as investing cash flows.

10.41 Paragraph 29 of FASB Statement No. 65 requires that the financial statements should disclose the method used in determining the lower of cost or market value of mortgage loans (that is, aggregate or individual loan basis).

10.42 As discussed in paragraph 7.101, paragraph 17 of FASB Statement No. 140, as amended by FAS Statement No. 156,[‡‡] requires certain disclosures about transfers and servicing of financial assets. Paragraph 17d of the Statement requires that, if it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, the entity must disclose a description of those items and the reasons why it is not practicable to estimate their fair value.

10.43 Paragraph 17e of FASB Statement No. 140, as amended by FAS Statement No. 156, requires that an entity disclose the following for all servicing assets and servicing liabilities:

a. Management's basis for determining its classes of servicing assets and servicing liabilities (paragraph 13A)

b. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities. (Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required.)

c. The amount of contractually specified servicing fees (as defined in the glossary), late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

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[9] AcSEC acknowledges that many financial institutions currently present such gains or losses separately on the face of the income statement. By requiring financial statement disclosure, AcSEC is not suggesting that this industry practice should be discontinued.

[‡‡] The disclosure requirements found in paragraph 17(d) of FASB Statement No. 140 have been amended by the issuance of FASB Statement No. 156. For additional information see footnote † in paragraph 10.19.

Auditing

Objectives

10.44 Audit objectives and procedures for loan origination and underwriting are discussed in Chapter 8, "Loans." Audit objectives and procedures for securities, including MBSs, are addressed in Chapter 7. The primary audit objectives in this area are to obtain reasonable assurance that:

a. Loans held for sale exist and are the property of the institution.

b. Loans held for sale are valued at the lower of cost or market value.

c. Loans held for sale are properly classified, described, and disclosed in the financial statements.

d. Escrow advances are properly recorded and collectibility is reasonably assured.

e. Gains and losses on the transfer of loans or servicing rights are properly measured, recorded, and disclosed.

f. Retained interests, obligations, and servicing rights are properly recognized and measured initially and on an ongoing basis.

g. Proper title has passed to the holder of purchased servicing rights.

h. Derivatives are properly identified, valued, recorded and disclosed.

Planning

10.45 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements,[10] which are described in Chapter 5 "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to loan transfers and mortgage banking activities. The independent accountant should

1. Obtain an understanding of loan transfer activities.
2. Inquire about the nature and frequency of transfers, the types of loans transferred, and the nature of obligations incurred.
3. Inquire about the bookkeeping and reporting systems employed both at the time of transfer and thereafter for retained interests and ongoing obligations.

10.46 The independent accountant should obtain an understanding of mortgage banking activities in which the institution is engaged. The independent accountant should inquire about how the mortgage banking activities relate to management's objectives for managing interest-rate risk and enhancing liquidity. The independent accountant should inquire about the reporting systems used by management to account for mortgage banking activities and should consider whether management has sufficient data to evaluate loan sale transactions, identify loans held for sale, and track mortgage loan commitments

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[10] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

and applications. Such information is usually needed to manage risks arising from mortgage banking activities.

10.47 Institutions acting as servicers of loans have a fiduciary responsibility to parties under the agreement. Failure to meet these responsibilities may result in contingent liabilities that could have a material effect on an institution's financial statements. Under contracts with third parties such as Ginnie Mae, Freddie Mac, Fannie Mae, and the Department of Housing and Urban Development (HUD), an institution must meet certain minimum net worth requirements. Failure to meet the requirements could result in termination of the servicing contract. In addition, the independent accountant should consider whether an institution's servicing systems ensure proper controls over investor and escrow accounts (for example, for taxes and insurance or loan principal and interest) and evaluate the potential for contingencies liabilities associated with noncompliance with investor-servicing requirements.

10.48 Contractual agreements with Ginnie Mae, Freddie Mac, Fannie Mae, HUD, or other investors may require engagements related to aspects of the contractual agreement or to the Uniform Single Attestation Program (USAP) for mortgage bankers. These agreements may require confirmation work on the actual loans being serviced under specific contracts.

Internal Control Over Financial Reporting and Possible Tests of Controls[11]

10.49 AU section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements* (AICPA, *Professional Standards*, vol. 1), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS). It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, as amended, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to 1) evaluate the design of internal controls and 2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risk of material misstatement at both the overall financial statement level and at the assertion level. In addition to the above, when performing an integrated audit of financial statements and internal control over financial reporting, in accordance with PCAOB standards, refer to AU section 319.97 (AICPA, *Professional Standards*, vol. 1) for a discussion on the extent of test of controls.[||||]

10.50 The discussions of internal control activities in Chapters 8 and 9 are also relevant to loan transfers and mortgage banking activities.

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[11] See footnote 1 on chapter 5 regarding the applicability of PCAOB Standards.

[||||] In December 2006, the PCAOB proposed Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, and Related Other Proposals*, that would supersede AS2 and all other previous PCAOB guidance related to that standardSee the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 2.

10.51 ***Policies and Procedures.*** Examples of typical internal control activities relating to financial reporting of mortgage banking activities include:

- Use of a quality control function to monitor underwriting and documentation practices
- Executive management review of open and pending commitments to buy or sell and strategies to minimize exposure to changing interest rates
- Loans sold with servicing retained are properly identified for derecognition
- Periodic reconciliation of cash receipts and payments applied to the servicing (custodial) system
- Periodic reconciliations of custodial accounts (the frequency of reconciliation should be determined by the level of account activity)
- Periodic reconciliation of servicing fees received to servicing fee income recorded in the general ledger
- Periodic evaluation of the recoverability of servicing rights and other capitalized costs
- Distinguishing loans held for sale from those held for investment

10.52 Examples of typical internal control activities relating to financial reporting of loan transfers include:

- Approval of sales by appropriate officers or committees
- Periodic reconciliations of detailed trial balances to the general ledger balance of loans held for sale
- Periodic review of the outstanding loans and locked-in borrower commitments for proper valuation
- Procedures in place to ensure that loan sale agreements are properly identified and valued
- Procedures in place to ensure that interest and fee income and gains/losses on sales are properly recorded, and information required for generally accepted accounting principles (GAAP) disclosures is available
- Procedures in place to ensure that retained interests and servicing rights and obligations are properly accounted for initially and on an ongoing basis
- Procedures in place to ensure that loans held for sale are properly identified

10.53 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Tests of controls that may be used to obtain evidence to support such an assessment include:

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts
- Reviewing custodial account reconciliations and supporting documentation to ensure that all activity is processed and cleared currently

- Selecting a sample of delinquent loans serviced and considering whether collection and follow-up procedures are performed on a timely basis and are in accordance with investor requirements
- Examining loan documentation (See Chapter 8.)

10.54 The following are tests of controls that may be used by the independent accountant to ensure that internal controls over financial reporting of loan transfers are operating effectively:

- Examine applicable loan sale and servicing agreements.
- Determine that the appropriate personnel understand the accounting treatment for sales of loans and related financial reporting implications.
- Examine accounting records to determine that verfication procedures are effectively performed to ensure interest and fee income and gains/losses on sales of loans are properly recorded.

Substantive Tests

10.55 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to transfers of loans and mortgage banking activities.

10.56 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of the risks of material misstatements. Substantive tests that the auditor should consider include:

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts
- Obtaining and testing the documentation supporting escrow and investor account reconciliations (Custodial accounts may be off-balance-sheet accounts. Accordingly, the independent accountant may need to select custodial accounts from records independent of the general ledger. In this case, the independent accountant may need to perform separate tests of the completeness and accuracy of custodial records.)
- Obtaining and testing supporting documentation for derivatives and related fair value determinations
- Evaluating the propriety of loan classifications to determine that all loans held for sale within the loan portfolio are properly identified (In evaluating whether loans are held for sale or in the loan portfolio, the independent accountant should consider management policy and practices, for example, previous loan sale activity, types of loans sold, transactions subsequent to year-end, and pending contracts, and whether management has the ability and intent to hold the loans for the foreseeable future or until maturity.)
- Reviewing the documentation and recalculating the amounts supporting the measurement of lower of cost or market valuation for loans held for sale

- Selecting a sample of loan sales made during the period and reviewing investor contracts to evaluate whether servicing assets and liabilities and sale-versus-financing treatment have been recognized properly
- Recalculating a sample of loan sale transactions to test calculation of weighted-average rates and corresponding gains or losses and vouching payments received for those transactions
- Analytically projecting service fees for comparison with service fee revenues reported in operating income for the period
- Evaluating the adequacy of valuation allowances for servicing and escrow advances (Some investors require that contractual interest and principal be remitted to them by the servicer regardless of mortgagor performance. Advances of such amounts are frequently made in anticipation of borrower performance and must be tracked on an individual basis to limit exposure to uncollectible advances.)
- For servicing rights, reviewing the assumptions used in the valuation process, considering their current reasonableness, and evaluating the effect of changes in assumptions on impairment
- Analyzing prepayment data used by management to calculate value of servicing rights at sale date and the systems used to update prepayment data over time for actual prepayment experience, selecting a sample of loan pools sold in prior periods, and comparing the actual current loan balance with estimates
- Evaluating the adequacy of the liability for recourse obligations (Loan sale/servicing agreements generally address recourse provisions and should be reviewed for all substantial investors to ensure that portfolios sold with recourse are included in recourse liability considerations.)
- Confirming selected loan balances serviced for others and related information directly with the borrower

Chapter 11

Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets[*]

Introduction

11.01 Generally, the largest component of real estate owned by lenders is assets taken in settlement of troubled loans through surrender or foreclosure. Real estate investments, real estate loans that qualify as investments in real estate, and premises that are no longer used in operations may also be included in real estate owned. Furthermore, institutions may obtain assets other than real estate through foreclosure, and those assets also are addressed in this chapter.

Foreclosed Assets

11.02 Foreclosed assets include all assets received in full or partial satisfaction of a receivable and include real and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts. Foreclosed assets also include loans that are treated as if the underlying collateral had been foreclosed because the institution has taken possession of the collateral, even though legal foreclosure or repossession proceedings have not taken place.[1]

Real Estate Investments

11.03 Some institutions make direct equity investments in real estate projects.

11.04 Further, in some loans accounted for as real estate investments, institutions have virtually the same risks and rewards as those of owners or joint venture participants. Such arrangements are treated as if the institution actually has an ownership interest in the property. In such arrangements, the lender participates in expected residual profits, which may be in the form of an equity kicker or a higher than usual effective interest rate. At the outset and during the construction and development of the property, the borrower generally has little or no equity in the property and the institution's only source of repayment is the property. The institution generally (*a*) agrees to provide substantially all funds to acquire, develop, and construct the property, (*b*) funds the commitment or origination fees or both, and (*c*) funds interest during the development and construction of the property.

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] Paragraph 13 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended, requires that, regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral if the creditor determines that foreclosure is probable. Further, paragraph 34 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended, provides that a troubled debt restructuring (TDR) that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39 of FASB Statement No. 15.

Regulatory Matters

11.05 The federal banking agencies jointly issued a policy statement on June 16, 1993, that addresses treatment of sales of real estate owned (REO) for regulatory financial reporting purposes.

11.06 Office of Thrift Supervision (OTS) policy does not automatically require general allowances on real estate owned. However, OTS policy states that an association should establish general allowances when the association is likely to experience losses on the disposition of REO in excess of any fair-value estimates, or is likely to incur costs during the holding period for REO that are not reflected in the carrying value. Also, OTS regulatory capital standards require certain real estate assets to be deducted from available regulatory capital.

11.07 Voluntary direct investments in real estate are generally limited for national banks, as described in Chapter 7 of the Code of Federal Regulations. State member banks may invest in real estate only with the prior approval of the Federal Reserve Board as described in Regulation H.

11.08 On December 6, 2006 the agencies issued interagency guidance titled Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, with notice provided in the Federal Register. The guidance provides a principle based discussion of supervisory expectations, as well as sound methods for evaluating capital adequacy. The agencies are concerned that banks have not evaluated and updated their risk management practicies and capital levels in spite of increased reliance on commercial real estate (CRE) concentrations.

Accounting and Financial Reporting

Foreclosed Assets

11.09 Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*,[2] established guidance on the accounting for and the reporting of foreclosed assets. FASB Statement No. 144 requires that long-lived assets to be disposed of be reported at the lower of carrying amount or fair value less cost to sell and to cease depreciation (amortization), except for assets that are covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended. (Assets within the scope of APB Opinion No. 30 are reported at the lower of carrying amount or net realizable value.) The accounting for long-lived assets to be disposed of other than by sale is addressed in paragraphs 27 and 28 of FASB Statement No. 144.

11.10 SOP 01-6 states that foreclosed and repossessed assets should be classified as a separate balance-sheet amount or included in other assets in the

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[2] The staff of the FASB issued FASB Staff Position (FSP) FAS 144-1, *Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15*, Accounting by Debtors and Creditors for Troubled Debt Restructurings, *and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets.

balance sheet, with separate disclosure in the notes to the financial statements. Certain returned or repossessed assets, such as inventory, should not be classified separately if the assets subsequently are to be utilized by the entity in operations.

11.11 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. This Statement revised language contained in paragraph 10 of FASB Statement No. 140. As a result, the language in SOP 01-6, paragraph 8(h), will be revised to remove reference to paragraph 10(b) of FASB Statement No. 140. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

Accounting and Reporting for Long-Lived Assets to Be Disposed of by Sale

11.12 Paragraph 30 of FASB Statement No. 144 states that a long-lived asset (asset group) to be sold shall be classified as held for sale in the period in which all of the following criteria are met:

a. Management, having the authority to approve the action, commits to a plan to sell the asset (disposal group).

b. The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).

c. An active program to locate a buyer and other actions required to complete the plan to sell the asset (disposal group) have been initiated.

d. The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year, except as permitted by paragraph 31 of FASB Statement No. 144.

e. The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

11.13 If, at any time, the preceding criteria are no longer met (except as permitted by paragraph 31 of FASB Statement No. 144), a long-lived asset (disposal group) classified as held for sale shall be reclassified as held and used in accordance with paragraph 38 of FASB Statement No. 144.

11.14 Paragraph 34 of FASB Statement No. 144 states that a long-lived asset (disposal group) classified as held for sale shall be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) shall be established based on its fair value less cost to sell at the acquisition date. A long-lived asset shall not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held-for-sale shall continue to be accrued.

11.15 In accordance with paragraph 37 of FASB Statement No. 144, a loss shall be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain shall be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized (for a write-down to fair value less cost to sell). The loss or gain shall adjust only the carrying amount of a long-lived asset, whether classified as held for sale individually or as part of a disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset (disposal group) shall be recognized at the date of sale.

11.16 Paragraph 45 of FASB Statement No. 144 states that a gain or loss recognized for a long-lived asset (disposal group) classified as held for sale that is not a component of an entity shall be included in income from continuing operations before income taxes in the income statement. If a subtotal such as "income from operations" is presented, it shall include the amounts of those gains or losses.

11.17 As stated in paragraph 46 of FASB Statement No. 144, a long-lived asset classified as held for sale shall be presented separately in the statement of financial position. The assets and liabilities of any disposal group classified as held for sale shall be presented separately in the asset and liability sections, respectively, of the statement of financial position. Those assets and liabilities shall not be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale shall be separately disclosed either on the face of the statement of financial position or in the note to the financial statements.

11.18 Paragraph 47 of FASB Statement No. 144 states the information that is required to be disclosed in the notes to the financial statements that cover the period in which a long-lived asset (disposal group) either has been sold or is classified as held for sale.

Accounting and Reporting for Long-Lived Assets to Be Held and Used

11.19 Paragraph 8 of FASB Statement No. 144 requires that a long-lived asset (asset group) to be held and used by an institution be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use or under development. FASB Statement No. 144 requires that, estimates of future cash flows used to test recoverability of a long-lived asset (asset group) shall include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with and that are expected to arise as a direct result of the use and eventual disposition of the asset (asset group). Those estimates should exclude interest charges that will be recognized as an expense when incurred.

11.20 FASB Statement No. 144, paragraph 7, states that *impairment* is the condition that exists when the carrying amount of a long-lived assets (asset group) exceeds its fair value. An impairment loss shall be recognized only if the carrying amount of the long-lived asset (asset group) is not recoverable and exceeds its fair value. An impairment loss shall be measured as the amount by which the carrying amount of the long-lived asset (asset group) exceeds its fair value. Paragraphs 10 and 11 of Statement 144 provide guidance on asset groups.

11.21 When a long-lived asset (asset group) is tested for recoverability, paragraph 9 of FASB Statement No. 144 states that it also may be necessary to review depreciation estimates and methods as required by FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, or the amortization period as required by FASB Statement No. 142, *Goodwill and Other Intangible Assets*.[3,4] Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability. However, any change in the accounting method for the asset resulting from that review shall be made only after applying FASB Statement No. 144.

11.22 If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

11.23 In accordance with paragraph 25 of FASB Statement No. 144, an impairment loss recognized for a long-lived asset (asset group) to be held and used shall be included in income from continuing operations before income taxes in the income statement. If a subtotal such as "income from operations" is presented, it shall include the amount of that loss. Paragraph 26 of FASB Statement No. 144 lists the information that shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized.

11.24 As stated in paragraph 26 of FASB Statement No. 144, the following information shall be disclosed in the notes to the financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment

b. If not separately presented on the face of the income statement, the amount of the impairment loss and the caption in the income statement

c. The method or methods for determining fair value (whether based on a quoted market price, prices for similar assets, or another valuation technique)

d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*[5]

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[3] The staff of the FASB issued FSP FAS 141-1 and FAS 142-1, *Interaction of FASB Statements No. 141*, Business Combinations, *and No. 142*, Goodwill and Other Intangible Assets, *and EITF Issue No. 04-2*, *Whether Mineral Rights Are Tangible or Intangible Assets*. If the guidance in the FSP results in the recharacterization of an asset, prior-period amounts on the statements of financial position should be reclassified. Any effects on amortization or depreciation of the asset should be accounted for prospectively.

[4] Paragraphs 19–22 of FASB Statement No. 154 address the accounting for changes in accounting estimates. Paragraph 11 of FASB Statement No. 142, as amended by FSP 141-1 and 142-2 (see footnote 3), addresses the determination of the useful life of an intangible asset.

[5] The FASB issued EITF Issue No. 04-10, *Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds*, to provide additional guidance in determining the aggregating of operating segments.

Real Estate Investments

11.25 AICPA Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures*,[6] SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*,[7] and FASB Statements No. 34, *Capitalization of Interest Cost*; No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*; No. 66, *Accounting for Sales of Real Estate*; and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, No. 152, *Accounting for Real Estate Time-Sharing Transactions, an amendment of FASB Statements No. 66 and 67*,[8] establish generally accepted accounting principles (GAAP) for real estate investments.

11.26 The AICPA's Notice to Practitioners on acquisition, development, and construction (ADC) arrangements requires that certain ADC arrangements be accounted for as investments in real estate (in conformity with FASB Statements No. 66 and No. 67) or real estate joint ventures (in conformity with the provisions of SOP 78-9[9] and FASB Statement No. 34, as amended by FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*), rather than as loans.[10] As discussed in the Notice to Practitioners, ADC arrangements accounted for as investments in real estate or real estate joint ventures should not be reported as loans in the balance sheet.

Sale of Real Estate Assets

11.27 FASB Statement No. 66 establishes GAAP for recognition of profit on all real estate sales transactions, including sales of foreclosed real estate assets. FASB Statement No. 66 provides criteria for determining whether a sale has occurred and, if so, the appropriate method of profit recognition. Further, FASB Statement No. 66 establishes GAAP for sale recognition for transactions that do not include gains. The six primary methods of accounting for sales transactions are full accrual, installment, percentage of completion, reduced profit, cost recovery, and deposit. If a company is selling discrete real estate projects, it may need to consider the "component of an entity" issue such that these may need to be reported as discontinued operations in accordance with FASB Statement No. 144. Other guidance on accounting for real estate sales that may apply includes FASB Statement No. 152, *Accounting for Real Estate*

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[6] The staff of the FASB has issued FSP SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9*, and EITF Issue No. 04-5 effective for new formed and existing general partnerships with agreement modifications after June 29, 2005. For general partners in all other partnerships the guidance is effective no later than the beginning of the first reporting period in fiscal years beginning December 15, 2005. Application of either transition methods described in the FSP are permitted.

[7] SOP 04-2 should be applied to financial statements for fiscal years beginning after June 15, 2005. Initial application of this SOP should be reported as a cumulative effect of a change in accounting principle, as described in FASB Statement No. 154. When adopting this SOP, an entity is not required to report the pro forma effects of retroactive application. An entity is required to disclose the effect of adopting this SOP on income before extraordinary items and on net income (and on the related per share amounts) of the period of the change. An entity should not restate previously issued financial statements.

[8] FASB Statement No. 152 is effective for financial statements for fiscal years beginning after June 15, 2005. Restatement of previously issued financial statements is not permitted.

[9] See footnote 6 in paragraph 11.25.

[10] The Notice appears as Exhibit I in AICPA Practice Bulletin No. 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, and gives guidance on determining whether an ADC arrangement should be treated as an investment in real estate or as a loan. Chapter 8 on loans applies to ADC arrangements that are considered loans.

Time-Sharing Transactions, an amendment of FASB Statements No. 66 and 67, FASB Interpretation No. 43, *Real Estate Sales*, and the following matters discussed by the FASB's Emerging Issues Task Force (EITF).

- Issue No. 84-17, *Profit Recognition on Sales of Real Estate With Graduated Payment Mortgages or Insured Mortgages*
- Issue No. 86-6, *Antispeculation Clauses in Real Estate Sales Contracts*
- Issue No. 86-7, *Recognition by Homebuilders of Profit From Sales of Land and Related Construction Contracts*
- Issue No. 87-9, *Profit Recognition on Sales of Real Estate With Insured Mortgages or Surety Bonds*
- Issue No. 88-12, *Transfer of Ownership Interest as Part of Down Payment Under FASB Statement No. 66*
- Issue No. 88-21, *Accounting for the Sale of Property Subject to the Seller's Preexisting Lease*
- Issue No. 88-24, *Effect of Various Forms of Financing Under FASB Statement No. 66*

Development Costs

11.28 Costs directly attributable to the acquisition, development, and construction of a real estate project should be capitalized in conformity with FASB Statement No. 67. Such costs include (*a*) options and other preacquisition costs, (*b*) direct project costs, (*c*) holding costs, including real estate taxes and insurance during the period in which activities of a substantive nature necessary to get the real estate ready for use are in progress, and (*d*) direct amenity costs, net of incidental operations during the holding period. A valuation allowance should be established for the excess of capitalized costs over the fair value of the foreclosed asset or the net realizable value of the real estate investment.

11.29 Whenever practical, costs including amenities should be allocated to components of a project on the basis of specific identification. If specific identification is not practical, (*a*) land costs and all other common costs incurred prior to construction should be allocated based on the relative fair value of each land parcel before construction and (*b*) construction costs should be allocated on the basis of the relative sales values of each unit. If allocation based on relative values is also impractical, costs should be allocated based on square footage or other methods as appropriate under the circumstances.

Allocation of Income and Equity Among Parties to a Joint Venture

11.30 If a real estate investment is made through a joint venture arrangement, a formal agreement generally exists that specifies key terms, such as profit or loss allocations, cash distribution, and capital infusion provisions. The terms of these agreements may affect the institution's investment valuation and, accordingly, should be considered in the investment evaluation process. Some joint venture agreements specify different ratios for allocating income, losses, cash distributions, liquidation distributions, and the like, between partners. In these circumstances, accounting by investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and a consideration of the underlying values. If a specified allocation has no substance (for example, all depreciation is to be allocated to one partner but all cash distributions, including proceeds from the sale of real estate, are shared equally by all partners), it should be ignored. The agreement should be analyzed to determine how changes in net assets of the venture will affect cash payments to investors over the venture's life and at liquidation. Paragraph 25 of SOP 78-9 provides further guidance on the allocation of income and equity among parties to a joint venture. Specified profit and loss ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis.

11.31 The institution should consider whether it is appropriate to allocate to other partners losses in excess of their capital contributions or whether the institution should record losses in excess of its own investment, including loans and advances. Items that may affect the institution's decision are (*a*) the financial strength of the partners, (*b*) the type of partners (general versus limited) and the partners' legal requirement to fund losses, (*c*) the fair value of the real estate, and (*d*) the type of losses being incurred (cash or book). Paragraphs 14 through 20 of SOP 78-9 provide guidance on investor accounting for losses in such circumstances.

11.32 The provisions in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003)[11,12,13] (FIN No. 46(R)) should be considered for real estate held in joint ventures or partnerships. FIN No. 46(R)

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[11] Application of FIN No. 46(R) is required for public entities that have interests in entities that are commonly referred to as variable interest entities. Application by small business issuers to *variable interest entities* other than *special-purpose entities* and by nonpublic entities to all types of *variable interest entities* are required at various dates in 2004 and 2005.

[12] The FASB issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs are, FIN 46(R), FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 replaced FIN 46-2, FIN 46-5, and FIN 46-8, respectively, with the effective dates and transition periods applied accordingly.

5. FSP FIN 46(R)-5 "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*" (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) For entities to which Interpretation 46(R) has been applied, the guidance in this FSP was applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) is permitted but not required. Early application was permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP is applied in accordance with the effective date and transition provisions of Interpretation 46(R).
6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46,

(continued)

clarified the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support.

Auditing

Objectives

11.33 The primary objectives of audit procedures in the real estate investments, real estate owned, and other foreclosed assets area are to obtain reasonable assurance that:

a. The assets exist and are owned by the institution.

b. The assets are properly classified, described, and disclosed in the financial statements.

c. Adequate provisions have been made for impairment, if any, of the assets.

d. Depreciation expense, where applicable and other revenues and expenses related to real estate assets are properly allocated and reported.

e. Sales of assets, including the recognition of gains and losses, have been recognized.

f. Appropriate disclosures have been made.

Planning

11.34 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements,[14] which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to real estate investments, real estate owned, and other foreclosed

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(footnote continued)

Consolidation of Variable Interest Entities." Effective for all arrangements to which FIN 46 has been or will be applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change should have been reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).

7. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)." An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

[13] For additional assistance, refer to the AICPA's Technical Practice Aid (TPA) 1400.29, "Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf).

[14] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

assets. In obtaining that understanding, the independent accountant should consider the following factors that may indicate higher inherent risk in this area.

- Adverse environmental or economic conditions that may affect real estate markets and the values and liquidity of properties or other assets
- Significant losses on past sales of real estate owned or other foreclosed assets
- Complex real estate assets
- Sales, financed by the institution, of real estate owned or other foreclosed assets
- Lack of experienced real estate staff
- High concentrations of real estate or other assets in a particular geographic area
- Significant fluctuations in the amount and number of foreclosures or in-substance foreclosures
- Inexperienced internal appraisal personnel or the use of low-quality or outdated appraisals

Internal Control Over Financial Reporting and Possible Tests of Controls[15]

11.35 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* (AICPA, *Professional Standards*, vol. 1), establishes requirement and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS). It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatement. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring), sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatements at both the overall financial statement level and at the assertion level.

11.36 Inherent risk is often high for foreclosed assets and ADC arrangements because of the high degree of subjectivity involved in determining real estate values and the classification of ADC arrangements. However, with a high level of inherent risk in the real estate area, the independent accountant would often conclude that for most of the assertions it is more effective or efficient to assess control risk at the maximum and plan a primarily substantive approach, involving a selection of major real estate assets for detailed review.

11.37 To plan the audit, the independent accountant should obtain a sufficient understanding of internal control over the financial reporting of individually significant real estate owned and other foreclosed assets. The auditor

[15] See footnote 1 in Chapter 5 regarding the applicability of PCAOB standards.

should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Internal controls over financial reporting of real estate investments, real estate owned, and other foreclosed assets may include:

- Written policies and procedures, including those that address:
  - Frequency of appraisals and selection and qualifications of appraisers
  - Disbursement of funds
  - Evaluation of management companies
  - Review and monitoring of marketing efforts
  - Nature and amount of facilitating financing
  - Revenue recognition
  - Cost to sell
  - Capitalization of interest
- Proper authorizations for specific transactions
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy

11.38 Audits performed in accordance with PCAOB standards.[†] Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 (AICPA, *Professional Standards*, vol. 1) for a discussion on the extent of test of controls. Also, refer to Appendix B, in Auditing Standard No. 2 paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing decisions.

Substantive Tests

11.39 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to real estate investments, real estate owned, and other foreclosed assets.

11.40 ***Other Real Estate Owned and Real Estate Investments.*** Obtaining audit evidence about the carrying amount of foreclosed assets (fair values) and real estate investments (including loans that qualify as real estate investments) may involve a review of appraisals, feasibility studies, forecasts, sales contracts or lease commitments, and information concerning the track record of the developer. In addition, the independent accountant should be alert

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[†] See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 2 and related conforming amendments to the PCAOB Standards.

to involvement of related parties and should design audit procedures accordingly. To obtain appropriate audit evidence of progress to completion under a real estate investment or other real estate project, the independent accountant may also decide to perform an on-site inspection of certain properties.

11.41 Substantive tests of other real estate and real estate investments generally focus on the valuation assertion; however, tests of the other assertions should also be considered. For example, evidence about the completeness assertion may be obtained through the independent accountant's testing of loans. In addition, the independent accountant should consider testing the propriety of gains and losses on real estate sales and capitalized interest and other holding costs.

11.42 Estimates of the fair value of real estate assets are necessary to account for such assets. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides guidance on auditing accounting estimates (such as estimates of fair values). AU section 342 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant evaluates the reasonableness of those estimates. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on auditing fair-value measurements and disclosures contained in financial statements. In particular, AU section 328 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Also, the AICPA nonauthoritative publication, *Auditing Estimates and Other Soft Accounting Information*, provides guidance for handling problems that arise in auditing estimates.

11.43 Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the independent accountant often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), and the AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information,* provide guidance in this area.

11.44 Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and, in some instances, the independent accountant may have reason to believe certain assumptions underlying appraisals are unrealistic. The independent accountant should understand and consider the approaches and assumptions used in obtaining the appraised value. Some matters that should be considered by the independent accountant when evaluating an appraisal are:

- A rise or decline in a particular market area not reflected in an appraisal may warrant that additional procedures, or perhaps a new appraisal, be performed.
- If the date of appraisal is substantially earlier than the audit date, a rise or decline in a particular market area between the two dates may warrant a new appraisal or the performance of additional procedures.

- Appraised values should be based on current market conditions and must be discounted for costs to complete and sell, as well as for carrying costs.
- The estimated selling prices should reflect the expectations of a sale in the reasonably near future—not in an indefinite future period.

11.45 Because of time and cost considerations, an institution may use various approaches to estimate value without using the services of an independent appraiser. In evaluating internally derived valuation data, the independent accountant should understand the methods and assumptions used and the qualifications of the individual performing the evaluation and should be aware of inherent subjective determinations in estimating value that may be significant to the valuation process. The independent accountant should consider the reasonableness of the assumptions and approach used and should test the information underlying the valuation. Further, the independent accountant may decide to engage an appraiser independent of the institution to test the institution's internally derived valuation. Despite the existence of an appraisal, in certain situations the independent accountant may wish to physically observe properties for the stage of completion, for deterioration, or for estimating the extent of occupancy.

11.46 The independent accountant should also evaluate whether significant real estate transactions qualify as sales in conformity with criteria set forth in FASB Statements No. 66 and No. 152 if applicable.

11.47 ***Other Foreclosed Assets.*** The procedures discussed above may be applied to other foreclosed assets to the extent that the independent accountant deems necessary.

Chapter 12

Other Assets, Other Liabilities, and Other Investments[*]

Introduction

12.01 The following assets are among those frequently grouped as *other assets* or *other investments* in institutions' balance sheets; however, any that are individually material should be presented in the balance sheet as a separate amount:

- Accrued interest receivable (see Chapter 7, "Investments in Debt and Equity Securities," for a discussion on securities and Chapter 8, "Loans," for a discussion on loans)
- Premises and equipment
- Other real estate, such as foreclosed assets (see Chapter 11, "Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets," for a discussion on real estate investments, real estate owned, and other foreclosed assets)
- Servicing assets (see Chapter 10, "Transfers of Loans and Mortgage Banking Activities," for a discussion of servicing assets)
- Federal Home Loan Bank (FHLB), Federal Reserve Bank (FRB), or other restricted stocks
- National Credit Union Share Insurance Fund (NCUSIF) deposits or other share insurance deposits
- Identifiable intangible assets, such as core deposit intangibles, and purchased credit-card relationships
- Goodwill
- Customers' liabilities on acceptances
- Deferred tax assets (see Chapter 16, "Income Taxes")
- Investments in equity securities that are not readily marketable (which meet definition of a security in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, but are not subject to its provisions because they are not readily marketable),[†] such as stock in the Federal Agricultural Mortgage Corporation (Farmer Mac) or stock in banker's banks
- Other equity investments, including investments in joint ventures or venture capital investments, and credit union investments in Credit Union Service Organizations (CUSOs)

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[†] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. Statement No. 159 serves as an amendment to FASB Statement No. 115. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The effective date is November 15, 2007. Entities may opt for early adoption of Statement 159, subject to conditions outlined in the Statement.

- Investments in nonnegotiable certificates of deposits (see Chapter 6, "Cash and Cash Equivalents")

12.02 Other liabilities frequently include the following:

- Accounts payable
- Accrued interest payable (see Chapter 13, "Deposits," for discussion of deposits)
- Accrued expenses
- Borrower's taxes and insurance escrows
- Bankers' acceptance liability
- Guarantee liabilities pursuant to FASB Interpretation No. 45
- Recourse liabilities
- Servicing liabilities
- Asset retirement obligations
- Liabilities associated with exit or disposal activities

Premises and Equipment

12.03 Premises and equipment consist primarily of land, buildings, furniture, fixtures, equipment, purchased software, and leasehold improvements used in institution operations. Such assets may be acquired directly or through a special-purpose subsidiary. Institutions may also lease property and equipment to other parties.

Federal Home Loan Bank or Federal Reserve Bank Stock

12.04 ***FHLB Stock.*** Institutions that are members of the FHLB system are required to maintain a minimum investment in FHLB stock. The minimum is calculated as a percentage of aggregate outstanding mortgages. An additional investment is required that is calculated as a percentage of total FHLB advances, letters of credit, and the collateralized portion of interest-rate swaps outstanding. FHLB stock is capital stock that is bought from and sold to the FHLB at $100 par. Both stock and cash dividends may be received on FHLB stock.

12.05 ***Federal Reserve Bank Stock.*** Members of the Federal Reserve System are required to maintain stock in the district Federal Reserve Bank in a specified ratio to its capital. The stock does not provide the owner with control or financial interest in the Federal Reserve Bank, is not transferable, and cannot be used as collateral. A member institution's ownership of Federal Reserve stock may be canceled in the event of the institution's insolvency or voluntary liquidation, conversion to nonmember status through merger or acquisition, or voluntary or involuntary termination of membership in the Federal Reserve System.

Identifiable Intangibles

12.06 Identifiable intangible assets may be acquired individually, as part of a group of assets, or in a purchase business combination. They include, among others, core deposit intangibles (the value of long-term deposit relationships), and credit-card customer lists (the value of long-term credit-card relationships).

Goodwill

12.07 Goodwill arises in a business combination. It represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognized as goodwill includes acquired intangible assets that do not meet the criteria in paragraph 39 of FASB Statement No. 141, *Business Combinations*, for recognition as assets apart from goodwill.

Customers' Liabilities on Acceptances

12.08 Customer's liabilities on acceptances represent a customer's outstanding debt to the institution that resulted from a banker's acceptance transaction. A banker's acceptance is a short-term negotiable time draft drawn on and accepted by an institution.

Other Miscellaneous Items

12.09 Other items that may be classified as other assets include accounts receivable, accruals for miscellaneous fees, other prepaid expenses, payroll deductions receivable, and suspense accounts. Suspense accounts usually contain amounts related to items recorded and held pending classification and transfer to the proper account and may originate from a variety of sources, such as loan remittances, branch clearing transactions, automated teller machine (ATM) transactions, and payroll transactions. Suspense accounts are generally recorded within "other liabilities" in the balance sheet but may have debit balances.

Regulatory Matters

12.10 Section 107(4) of the Federal Credit Union Act (FCUA), as well as many state statutes, allow credit unions to purchase, hold, and dispose of only that property which is necessary or incidental to their operations. Credit unions are limited by regulatory authorities to a maximum investment in property and equipment. This limitation also includes lease payments. Credit unions may also be prohibited from acquiring real property from certain related parties. Credit unions that qualify for the Regulatory Flexibility Program (Reg-Flex) can be subject to less strict regulation in this area. Reg-Flex credit unions have the percentage of total assets limitations removed for purchases of fixed assets.

12.11 Banks and savings institutions are generally limited in the type and amount of intangible assets that may be included in regulatory capital. In addition to these limits, for purposes of calculating Tier 1 capital, the amount of servicing assets (SAs) and purchased credit-card relationships (PCCRs) that institutions can include in Tier 1 capital cannot exceed 90 percent of their fair market value.

12.12 Both national banks and state member banks are limited as to the amount of their investments in bank premises. National bank limitations are set forth in 12 USC 371d. State member bank limitations are set forth in 12 CFR 208.22.

12.13 See paragraph 10.09 for information on interagency guidelines on asset securitization.

Accounting and Financial Reporting

Premises and Equipment

12.14 Institutions account for premises and equipment in the same way that commercial enterprises account for property and equipment (fixed assets). Institutions carry premises and equipment on the balance sheet at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Capital additions and improvements to premises should be capitalized, including construction period interest capitalized in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost*. Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, paragraph B.14(c) states that for premises and equipment, net gains or net losses on dispositions should be included in noninterest income or non-interest expense. A description of the institution's depreciation and capitalization policies should be included in the notes to the financial statements.

12.15 Premises and equipment held for use need to be tested for impairment. Premises and equipment may include capital leases, which should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*,[1] and are subject to the requirements of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*,[2,3] for purposes of recognizing and measuring impairment. Readers may refer to paragraph 12.42 for further guidance on impairment. Consolidation of subsidiaries that own premises should occur in accordance with FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries.* In addition, to address consolidation by business entities with certain characteristics, FASB Interpretation No. 46,[4,5,6]

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[1] The staff of the FASB has issued FASB Staff Position (FSP) 13-1, *Accounting for Rental Costs Incurred during a Construction Period*. The guidance in this FSP shall be applied to the first reporting period beginning after December 15, 2005. Early adoption is permitted for financial statements or interim financial statements that have not been issued.

[2] The staff of the FASB issued FASB Staff Position (FSP) FAS 144-1, *Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15*, Accounting by Debtors and Creditors for Troubled Debt Restructurings, *and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets.

[3] The AICPA issued a technical practice aid discussing several practice issues, including the amortization of leasehold improvements, rent holidays, and leasehold improvement incentives. For additional information visit the AICPA Web site.

[4] Application of FIN No. 46(R) is required for public entities that have interests in entities commonly referred to as variable interest entities. Application by small business issuers to *variable interest entities* other than *special-purpose entities* and by nonpublic entities to all types of *variable interest entities* was required at various dates in 2004 and 2005.

[5] The FASB issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."

(continued)

Consolidation of Variable Interest Entities (revised December 2003) (FIN No. 46(R)), clarified the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support.

12.16 FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases*, provides guidance on how to account for sale-leaseback transactions, and the FASB's Emerging Issues Task Force (EITF) has reached consensus on various sale-leaseback matters, such as:

- Issue No. 84-37, *Sale-Leaseback Transaction With Repurchase Option*.
- Issue No. 86-17, *Deferred Profit on Sale-Leaseback Transaction With Lessee Guarantee of Residual Value*.

12.17 SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, provides guidance on accounting for the costs of computer software developed or obtained for internal use. Accounting for the cost of internally developed and purchased computer software to be sold, leased,

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(footnote continued)

4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs, FIN 46(R), FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 replaced FIN 46-2, FIN 46-5, and FIN 46-8, respectively, with the effective dates and transition periods applied accordingly.

5. FSP FIN 46(R)-5 "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*" (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) For entities to which Interpretation 46(R) has been applied, the guidance in this FSP are applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) was permitted but not required. Early application was permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).
6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*." Effective for all arrangements to which FIN 46 has been or will be applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change should have been reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).
7. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No.46(R)" An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006.

[6] For additional assistance, refer to the AICPA's Technical Practice Aid (TPA) 1400.29, "Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*" (www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf).

or otherwise marketed is established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*.

12.18 Premises and equipment are generally shown as a single caption on the balance sheet, net of accumulated depreciation and amortization, the amount of which must be disclosed either on the face of the balance sheet or in the notes to the financial statements. If the individual categories of assets are material, they should be disclosed on the face of the balance sheet or in the notes to the financial statements. The amount of assets under capitalized leases should be disclosed.

12.19 ***Operating Leases.*** An operating lease is one that fails to meet any of the capital lease criteria, as specified in paragraph 7 of FASB Statement No. 13. From the lessor's perspective, the leased assets are recorded on the balance sheet and lease payments are recognized as rental income in the income statement in accordance with paragraph 19 of FASB Statement No. 13. Assets leased by the lessor under assets subject to operating leases are also subject to the requirements of FASB Statement No. 144[7] for purposes of recognizing and measuring impairment. From the lessee's perspective, lease payments are recognized as rental expense in the income statement in accordance with paragraph 15 of FASB Statement No. 13.

FHLB or Federal Reserve Bank Stock

12.20 On June 23, 2004, the FHFB voted to require the 12 federal home loan banks to enhance their financial disclosures by registering with the SEC. Each bank will now be required to register a class of its equity securities under Section 12(g) of the Securities and Exchange Act of 1934. The banks will file quarterly, annual, and supplemental disclosures. The first Form 10s must be filed no later than June 30, 2005, and registrations must be effective by August 29, 2005.

12.21 Although FHLB (or FRB) stock is an equity interest in a FHLB (or FRB), it does not have a readily determinable fair value for purposes of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,[8] because its ownership is restricted and it lacks a market. FHLB (or FRB) stock can be sold back only at its par value of $100 per share and only to the FHLBs (or FRBs) or to another member institution. SOP 01-6 states that FHLB and FRB stock should be classified as a restricted investment security, carried at cost, and evaluated for impairment.

12.22 In addition, the equity ownership rights represented by FHLB stock are more limited than would be the case for a public company, because of the oversight role exercised by the Federal Housing Finance Board (FHFB) in the process of budgeting and approving dividends.

12.23 SOP 01-6, paragraph 8(*i*), states that SOP 01-6, both cash and stock dividends received on FHLB stock are reported as income. The stock dividends are redeemable at par value.

12.24 SOP 01-6 states that FHLB stock is generally viewed as a long-term investment. Accordingly, when evaluating FHLB stock for impairment, its

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[7] See footnote 3.

[8] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in this FSP should be applied to reporting period beginning after December 15, 2005.

value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value.[9] The determination of whether the decline affects the ultimate recoverability is influenced by criteria such as the following:

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted
- Commitments by the FHLBs to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBs
- The impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLBs
- The liquidity position of the FHLBs

12.25 The evaluation of whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock is ultimately made by the member institution based on the facts at the time. This consideration is influenced by (*a*) the materiality of the carrying amount to the member institution and (*b*) whether an assessment of the institution's operational needs for the foreseeable future would require and allow management to dispose of the stock.

12.26 Classification of FHLB or Federal Reserve Bank stock in the balance sheet varies among financial institutions. Some institutions, with more significant investments in FHLB or Federal Reserve Bank stock, present their investment as a separate line item in the balance sheet. Others may combine the investment in FHLB or Federal Reserve Bank stock with other investments or other assets. Either manner of presentation is acceptable. However, investments in FHLB or Federal Reserve Bank stock should not be shown with securities accounted for under FASB Statement No. 115.[10]

Intangible Assets

12.27 In accordance with paragraph 9 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, an intangible asset that is acquired either individually or with a group of other assets (but not those acquired in a business combination) shall be initially recognized and measured based on its fair value. Chapter 19 discusses intangible assets in connection with a business combination.

12.28 Costs of internally developing, maintaining, or restoring intangible assets (including goodwill) that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole, shall be recognized as an expense when incurred in accordance with paragraph 10 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

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[9] When addressing other than temporary impairment, readers may also refer to Emerging Issues Task Force Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and the FASB Staff Positions FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in FSP 115-1 and FAS 124-1 should be applied to reporting period beginning after December 15, 2005.

[10] See footnote 9 in paragraph 12.24.

12.29 The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite life is amortized; an intangible asset with an indefinite useful life is not amortized. The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, including those described in paragraph 10 of FASB Statement No. 142.[11] If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term indefinite does not mean infinite.

12.30 As required by paragraph 12 of FASB Statement No. 142, if an intangible asset has a finite useful life, but the precise length of that life is not known, that intangible asset shall be amortized over the best estimate of its useful life. The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used. An intangible asset shall not be written down or off in the period of acquisition unless it becomes impaired during that period.

12.31 The amount of an intangible asset to be amortized shall be the amount initially assigned to that asset less any residual value.

12.32 Paragraph 14 of FASB Statement No. 142 requires that an entity shall evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. If the estimate of an intangible asset's remaining useful life is changed, the remaining carrying amount of the intangible asset shall be amortized prospectively over that revised remaining useful life. If an intangible asset that is being amortized is subsequently determined to have an indefinite useful life, the asset shall be tested for impairment in accordance with paragraph 17 of FASB Statement No. 142 (Paragraph 8 of FASB Statement No. 144, includes examples of impairment indicators). That intangible asset shall no longer be amortized and shall be accounted for in the same manner as other intangible assets that are not subject to amortization.

12.33 Paragraph 15 of FASB Statement No. 142 states that an intangible asset that is subject to amortization shall be reviewed for impairment in accordance with FASB Statement No. 144 by applying the recognition and measurement provisions in paragraphs 7–24 of that Statement. In accordance with FASB Statement No. 144, an impairment loss shall be recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

12.34 If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite, as required by paragraph 16 of FASB Statement No. 142. An entity shall

[11] Paragraph 11 of FASB Statement No. 142 has been amended by issued FSP FAS 141-1 and FAS 142-1, *Interaction of FASB Statements No. 141*, Business Combinations, *and No. 142*, Goodwill and Other Intangible Assets, *and EITF Issue No. 04-2, Whether Mineral Rights Are Tangible or Intangible Assets*.

evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life. If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance with paragraph 17[12] of FASB Statement No. 142. That intangible asset shall then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

12.35 In accordance with paragraph 17[13] of FASB Statement No. 142, an intangible asset that is not subject to amortization shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test shall consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

12.36 ***Accounting for Goodwill.*** Goodwill shall not be amortized. Goodwill shall be tested for impairment at a level of reporting referred to as a reporting unit. (Paragraphs 30 to 36 of FASB Statement No. 142 provide guidance on determining reporting units.) Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. Paragraphs 19 to 22 of FASB Statement No. 142 describe a two-step impairment test that shall be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any). Paragraphs 23 to 41 provide further, detailed guidance on accounting for goodwill.

12.37 ***Financial Statement Presentation.*** Paragraph 42 of FASB Statement No. 142 states that at a minimum, all intangible assets shall be aggregated and presented as a separate line item in the statement of financial position. However, that requirement does not preclude presentation of individual intangible assets or classes of intangible assets as separate line items. The amortization expense and impairment losses for intangible assets shall be presented in income statement line items within continuing operations as deemed appropriate for each entity. The aggregate amount of goodwill shall be presented as a separate line item in the statement of financial position. The aggregate amount of goodwill impairment losses shall be presented as a separate line item in the income statement before the subtotal *income from continuing operations* (or similar caption) unless a goodwill impairment loss is associated with a discontinued operation. A goodwill impairment loss associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations. Paragraphs 44 to 47 of FASB Statement No. 142 provide disclosure requirements for intangible assets and goodwill.

Exit or Disposal Activities

12.38 Exit activities include, but are not limited to, the closure of activities in a particular location, the relocation of activities from one location to another, changes in management structure, sale or termination of a line of business, or

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[12] See footnote 11.

[13] See footnote 11.

a fundamental reorganization that affects the nature and focus of operations. FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*,[14] discusses recognition of liabilities for the costs of exit activities, including one-time termination benefits provided to current employees that are involuntarily terminated, costs to terminate a contract that is not a capital lease, and costs to consolidate facilities or relocate employees.

Asset Retirement Obligations

12.39 FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, addresses financial accounting and reporting for obligations associated with the retirement (sale, abandonment, recycling, disposal, or other other-than-temporary idling) of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. FASB Statement No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs should be capitalized as part of the carrying amount of the long-lived asset.

12.40 The FASB has recently issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*. This Interpretation clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143. This Interpretation is effective no later than the end of fiscal years ending after December 15, 2005 (December 31, 2005, for calendar-year enterprises). Retrospective application for interim financial information is permitted but is not required.

Customers' Liabilities on Acceptances

12.41 Provisions for uncollectible amounts for customers' acceptance liabilities should be made, if necessary. Customers' liabilities on acceptances should be reported gross, rather than net of the related bankers' acceptance liability.

Impairment

12.42 FASB Statement No. 144 establishes the financial accounting and reporting for the impairment of long-lived assets to be held and used or to be disposed of, including (*a*) capital leases of lessees, and (*b*) long-lived assets of lessors subject to operating leases. See Chapter 11 for the requirements of FASB Statement No. 144.

National Credit Union Share Insurance Fund (NCUSIF) Deposit

12.43 SOP 01-6 states that federally insured credit unions are required to maintain on deposit with the NCUSIF an amount equal to 1 percent of the credit union's total insured shares. The amount on deposit is adjusted periodically for changes in the amount of a credit union's insured shares. For example, if the insured shares decline, a pro rata portion of the amount on deposit with the

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[14] The staff of the FASB issued FSP FAS 146-1, *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement*, for exit or disposal activities.

NCUSIF is refunded to the credit union. A credit union is also required to pay an annual insurance premium equal to one-twelfth of 1 percent of its insured shares, unless the payment is waived or reduced by the National Credit Union Association (NCUA) Board.

12.44 SOP 01-6, paragraph 11(*a*), states that amounts deposited with the NCUSIF should be accounted for and reported as assets as long as such amounts are fully refundable. The refundability of NCUSIF deposits should be reviewed for impairment. When the refundability of a deposit is evaluated, the financial condition of both the credit union and of the NCUSIF should be considered. Deposits may be returned to solvent credit unions for a number of reasons, including the termination of insurance coverage, conversion to insurance coverage from another source, or the transfer of operations of the insurance fund from the NCUA Board. However, insolvent or bankrupt credit unions are not entitled to a return of their deposits. To the extent that NCUSIF deposits are not refundable, they should be charged to expense in the period in which the deposits are made or the assets become impaired.

12.45 SOP 01-6, paragraph 11(*b*), states that in years in which the equity of the NCUSIF exceeds "normal operating levels," the NCUA Board is required to make distributions to insured credit unions to reduce the equity of the NCUSIF to normal operating levels. Such distributions may be in the form of a waiver of insurance premiums, premium rebates, or cash payments. Distributions in connection with that reduction in the equity of the NCUSIF should be reported in the income statement in the period in which it is determined that a distribution will be made.

12.46 SOP 01-6, paragraph 11(*c*), also states that the system of savings account insurance established by the recapitalization of the NCUSIF, which provided for reserves of 1 percent of insured deposits, is based on the concept that the required deposits create a fund with an earning potential sufficient to provide for the risk of losses in the credit union system. In years during which the earnings of the fund have been adequate to provide insurance protection and cover all expenses and losses incurred by the fund, the NCUA Board has elected to waive the insurance premiums due from insured credit unions. In those years, it has been industry practice to net imputed earnings on the insurance deposits against imputed premium expense rather than present them as gross amounts on the statement of income. In years during which the insurance premiums are not waived by the NCUA Board, the premiums should be expensed in the period to which they relate. To the extent that the NCUA Board assesses premiums to cover prior operating losses of the insurance fund or to increase the fund balance to "normal operating levels," credit unions should expense those premiums when assessed.

Other Investments

12.47 *Credit Union Service Organizations (CUSOs).* Credit unions are allowed under the NCUA regulations to own and operate outside entities that conduct business related to the general services of the credit union. The types of businesses are restricted as to operations within the regulations. These entities may conduct business with other credit unions, credit union members, and nonmembers. In addition, credit unions can own these entities with other credit unions or outside third parties.

12.48 Credit unions are restricted in the amount of money that can be invested in and loaned to the CUSO. Under current regulations, credit unions can lend and/or invest up to 1 percent of the credit union's unimpaired capital and surplus. The CUSO can be structured as a corporation, a limited liability company, or a limited partnership as long as the credit union is not the general partner. All CUSOs must follow GAAP, have an annual opinion audit, and prepare quarterly financial statements. The recording of the investment in or loan to the CUSO must also be accounted for in accordance with GAAP.

12.49 The following are the general approved categories of CUSOs within the regulations:

- Checking and currency services
- Clerical, professional and management services
- Consumer mortgage loan origination
- Electronic transaction services
- Financial counseling services
- Fixed-asset services
- Insurance brokerage services
- Leasing
- Loan support services
- Securities brokerage services
- Shared branching
- Student loan origination
- Travel agency
- Trust and trust-related services
- Non-CUSO service providers

12.50 Under current Internal Revenue Service (IRS) regulations, federally chartered credit unions do not have to pay taxes on income from flow-through entities. However, state chartered credit unions may be liable for taxes on flow-through income. All CUSOs must follow all relevant IRS and state reporting and filing requirements.

12.51 In accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*,[16] the equity method of accounting should be used if the institution has the ability to exercise significant influence over the operating and financial policies of the investee or CUSO. Majority owned subsidiaries should be included in the consolidated financial statements of the parent in accordance with FASB Statement No. 94 and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*. In addition, to address consolidation by business entities with certain characteristics, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003) (FIN No. 46(R)),[17] clarified the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support.

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[16] The staff of the FASB issued FSP APB 18-1, *Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion 18 upon a Loss of Significant Influence*. The guidance for the FSP is effective as of the first reporting period beginning after July 12, 2005.

[17] See footnotes 4 and 6 of this chapter.

Contributed Assets

12.52 Many credit unions receive substantial contributions (for example, use of facilities and utilities, telephone services, data processing, mail services, payroll processing services, pension administration services and pension plan contributions, and other materials and supplies) from their sponsoring organizations. Many credit unions also rely on volunteers to provide various services to their members; some credit unions are staffed exclusively by volunteers. In addition, credit unions occasionally receive contributions of assets of material value.

12.53 Generally, contributions received, including unconditional promises to give, should be recognized as revenue in the period received at their fair values and should be debited to the appropriate asset account, in accordance with paragraph 9 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. Contributions of services are recognized only if the services received (*a*) create or enhance nonfinancial assets or (*b*) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Paragraphs 10, 24, and 25 of FASB Statement No. 116 requires certain disclosures for receipts of contributed services and promises to give. Paragraph 19 states that quoted market prices, if available, are the best evidence of the fair value of monetary and nonmonetary assets, including services.

12.54 Paragraph 19 of FASB Statement No. 116 further states that if quoted market prices are not available, fair value may be estimated based on quoted market prices for similar assets, independent appraisals, or valuation techniques, such as the present value of estimated future cash flows. Contributions of services that create or enhance nonfinancial assets may be measured by referring to either the fair value of the services received or the fair value of the asset or of the asset enhancement resulting from the services. A major uncertainty about the existence of value may indicate that an item received or given should not be recognized. The future economic benefit or service potential of a tangible item usually can be obtained by exchanging it for cash or by using it to produce goods or services.

Auditing

Objectives

12.55 ***Other Assets.*** The primary objectives of audit procedures applied to other assets are to obtain reasonable assurance that:

a. The assets exist and are owned by the institution.

b. The assets are properly classified, described, and disclosed in the financial statements.

c. Intangible assets that should be amortized are being amortized on a consistent basis over the estimated period of benefit.

d. Adequate provisions have been made for impairment, if any, of the assets.

e. Sales of assets, including the recognition of gains and losses, have been properly recognized.

f. Appropriate disclosures, including the existence of liens, have been made.

12.56 ***Other Liabilities.*** The primary objectives of auditing other liabilities are to obtain reasonable assurance that:

- The liabilities represent authorized obligations of the institution.
- All contingencies and estimated current period expenses that will be paid in future periods that should be accrued during the period have been accrued, classified, and described in accordance with GAAP, and the related disclosures are adequate.

Planning

12.57 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Assessing the Risks of Material Misstatement*, (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements, which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to other assets and other liabilities. Presented below are examples of factors that may indicate higher risks of material misstatement for these areas:

- A current interest rate environment that may adversely affect the values of intangible assets that derive their value from (*a*) loan relationships or (*b*) from the timing and amount of future cash flows
- Loss of depositor relationships
- Operating losses
- Large unreconciled balances in suspense accounts
- Planned branch dispositions

Internal Control Over Financial Reporting and Possible Tests of Controls

12.58 AU section 314, *Understanding the Entity and Its Environment* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with generally accepted auditing standards. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain sufficient understanding of each of the five components (the control environment, risk assessment, control activities, information and communication, and monitoring) to 1) evaluate the design of internal controls and 2) determine whether they are implemented. The auditor is also required to assess the risks of material misstatements at both the overall financial statement level and at the assertion level.

12.59 Audits performed in accordance with PCAOB Standards. AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph .25 of AU section 319, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to plan the audit. A sufficient understanding is obtained by performing procedures The auditor is also required to assess control risk for the relevant assertions embodied in the account balances, transaction class, and disclosure components of the financial statements.

12.60 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Typical financial reporting controls may include:

- Written policies and procedures that, among other things, specify depreciation and amortization methods and periods for property and equipment
- Proper authorizations for specific transactions, such as approval for property and equipment purchases and sales
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy
- Written policies and procedures aimed at assessing possible impairment of assets on a periodic basis

12.61 Audits performed in accordance with PCAOB Standards.[‡] Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 (AICPA, *Professional Standards*, vol. 1) for a discussion on the extent of test of controls. Also, refer to Appendix B, in Audit Standard No. 2 paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing decisions.

Substantive Tests

12.62 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to other assets and other liabilities.

12.63 ***FHLB or Federal Reserve Stock.*** If the institution is a member of the FHLB or Federal Reserve System, the independent accountant should consider (*a*) confirming stock ownership with the related FHLB or Federal Reserve

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[‡] In December 2006, the PCAOB proposed Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, and Related Other Proposals*, that would supersede AS2 and all other previous PCAOB guidance related to that standard. See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 2 and related conforming amendments to the PCAOB Standards.

Bank and (*b*) reconciling the dollar amount of the shares with the institution's general ledger. For institutions holding FHLB stock, the independent accountant should consider the status of the FHLB's redemption of its stock at par value before concluding that income recognition is appropriate for any FHLB stock dividends.

12.64 ***Premises and Equipment.*** Substantive procedures used to test premises and equipment consist primarily of physical inspection, review of documents of title or other documents supporting the acquisition, tests of disposals and other adjustments, and reasonableness tests of depreciation. Similar procedures are often used to test the classification, recording, and disclosure of leased premises and equipment.

12.65 Independent accountants should be alert for signs that premises and equipment are no longer in use and consider tests to determine whether there are any undisclosed liens on premises and equipment. The independent accountant should also consider whether there is permanent impairment of the premises and equipment. Computer hardware and software are particularly vulnerable to obsolescence and their valuation should be reviewed.

12.66 ***Intangible Assets and Goodwill.*** Substantiating the amount of intangible assets requires careful judgment by the independent accountant. The independent accountant should determine that the amortization periods are reasonable and that the customer relationships from which the intangibles derive their value continue to exist at the balance-sheet date. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1) provides guidance on auditing accounting estimates (such as estimates of fair values). AU section 342 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used, and evaluates the reasonableness of those estimates. In this area, such key factors and assumptions may include the ability of the assets to generate income in the future, the expected lives of loans, or expected withdrawal rates of deposits. The independent accountant should consider whether the assumptions continue to be reasonable and evaluate the effect of changes in assumptions on the recoverability of the assets.

12.67 ***Customers' Liabilities on Acceptances.*** Substantive tests that are performed on loans, such as confirmation and collectibility reviews, are generally used to test customers' liabilities on acceptances. (See Chapters 8 and 9, "Credit Losses")

12.68 ***Other Liabilities.*** Substantive audit procedures relating to interest payable, accrued expenses, and other liability amounts that the auditor should consider performing include:

- Tracing recorded amounts to supporting documentation
- Agreeing rates used in the calculation of recorded amounts of interest payable to board of directors' authorization
- Testing individual calculations of accrued interest (dividends)
- Tracing recorded amounts to subsequent cash disbursements
- Examining evidence supporting the carrying amount of other liabilities, including such items as an actuarial evaluation used to compute accrued pension costs, payroll tax returns, and invoices received from third parties
- Confirming recorded amounts

- Performing a search for unrecorded liabilities
- Performing analytical procedures

12.69 ***Suspense Accounts.*** The independent accountant should consider reviewing the suspense account for material items remaining in the account at year-end for reclassification entries to the appropriate account. The independent accountant should also consider reviewing for subsequent entries made to clear suspense account items.

Chapter 13

Deposits[*]

Introduction

13.01 Deposits are an important source of funds for banks, credit unions, and savings institutions. Finance and mortgage companies do not take insured deposits. Because a credit union's members are also its owners, credit unions often refer to deposits as "share accounts" and related interest paid as "dividends." Some credit unions permit nonmembers to deposit funds subject to certain restrictions.

13.02 Deposits are often an institution's most significant liability and interest expense on deposits an institution's most significant expense. The predominance of negotiable certificates of deposit (CDs) and other kinds of interest-bearing deposits on which drafts can be made, the deregulation of interest rates paid on insured deposits, competition from mutual funds and other financial products, nondeposit liabilities as a source of funds, and liability management all have driven the offering of a wide range of deposit products having a variety of interest rates, terms, and conditions.

13.03 Deposits are generally classified by whether they bear interest, by their ownership (for example, public, private, interbank, or foreign), and by their type (for example, demand, time, and savings; or transaction and non-transaction). A description of various deposit products follows. These descriptions may not correspond to regulatory designations under Federal Reserve Board (FRB) Regulation D.

Demand Deposits

13.04 Demand deposits (often called *transaction accounts* or *DDAs*) are accounts that may bear interest and that the depositor is entitled to withdraw at any time without prior notice. Checking and negotiable order of withdrawal (NOW) accounts are the most common form of demand deposits. Withdrawals are typically made through check writing, automated teller machines (ATMs), point-of-sale (POS) terminals, electronic funds transfers (EFTs), or preauthorized payment transactions. Deposits are generally made through direct deposit (such as of payroll amounts) or EFTs, or at ATMs or teller windows.

13.05 Further, an institution may issue a check drawn on itself for a variety of purposes, such as expense disbursements, loan disbursements, dividend payments, withdrawal of account balances, and exchange for cash with customers. These checks are generally referred to as official checks and may consist of cashier's, treasurer's, expense, and loan disbursement checks and money orders.

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

Savings Deposits

13.06 Savings deposits bear interest and have no stated maturity. Savings deposits include passbook and statement savings accounts and money-market deposit accounts (MMDAs). Withdrawals and deposits are typically made at ATMs or teller windows, by EFTs, or by preauthorized payments. Furthermore, MMDAs generally permit the customer to write checks, although the number of checks that may be written is limited by law.

Time Deposits

13.07 Time deposits, which include CDs, individual retirement accounts (IRAs), and open accounts, bear interest for a fixed, stated period of time.

13.08 CDs bear a stipulated maturity and interest rate, payable either periodically or at maturity. CDs may be issued in bearer form (payable to the holder) or registered form (payable only to a specified individual or entity) and may be negotiable or nonnegotiable (always issued in registered form). Negotiable CDs, for which there is an active secondary market, are generally short term and are most commonly sold to corporations, pension funds, and government bodies in large denominations (generally, $100,000 to $1 million). Nonnegotiable CDs, including savings certificates, are generally in smaller denominations. Depositors holding nonnegotiable CDs may recover their funds prior to the stated maturity but must pay a penalty to do so.

13.09 Retirement accounts known as IRAs, Keogh accounts (also known as H.R. 10 plans), or self-employed-person accounts (SEPs) are generally maintained as CDs. However, because of the tax benefits for depositors, they typically have longer terms than most CDs. Many retirement accounts provide for automatic renewal on maturity.

13.10 Open accounts are time deposits with specific maturities and fixed interest rates but, unlike savings certificates, amounts may be added to them until maturity. Common types of open accounts are vacation and Christmas club accounts.

13.11 Brokered deposits are time deposits that are third-party deposits placed by or through the assistance of a deposit broker. Deposit brokers sometimes sell interests in placed deposits to third parties. As discussed below, federal law restricts the acceptance and renewal of brokered deposits by an institution based on its capitalization.

13.12 Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a depository institution. Institutions record such deposits, which are non-interest-bearing, as treasury tax and loan accounts (TT&L accounts) and include such accounts with their deposits. (See Chapter 15, "Debt," paragraph 15.18.)

Dormant Accounts

13.13 Institutions generally have a policy on classifying accounts as dormant. The required period of inactivity before savings accounts are classified as dormant normally exceeds that for checking accounts because savings accounts are normally less active. After a specific period of inactivity, as determined by the state in which the institution is located, the accounts may no longer be deposits of the institution and may be required to be turned over to (escheat to) the state.

Closed Accounts

13.14 When an account is closed, the signature card is generally removed from the file of active accounts and placed in a closed-account section.

Other Deposit Services

13.15 Institutions often offer other deposit services such as reserve or overdraft protection programs[1] (which combine a checking account and a preauthorized personal loan), check guarantee services, and consolidated account statements (which combine the account information of several services into one monthly statement).

The Payments Function and Services

13.16 The payments function of a depository institution involves facilitating money payments and transferring funds. The payments function is accomplished through checks and EFTs.

13.17 ***Check Processing.*** The check-clearing process, which is highly automated, involves the exchange of checks and the settlement of balances among institutions locally, regionally, and nationally. Check processing involves the encoding of checks with magnetic ink character recognition (MICR) symbols to facilitate routing, the proof and transit function, and the flow of checks for collection. A correspondent system and the Federal Reserve perform such clearinghouse functions for depository institutions.

13.18 An institution receives two types of checks: (*a*) on-us checks, drawn on a depositor's account and (*b*) foreign checks, drawn on accounts of other institutions. Such checks may be received from the Federal Reserve, local clearinghouses, other depository institutions, at an ATM or teller window, through the mail, or by other means, such as a loan payment.

13.19 Many checks that an institution receives have been dollar-amount encoded by the first institution that handles the check. However, checks received through an institution's own operations must go through its proof department or its correspondent bank. A proof department has the responsibility to:

a. Prove the individual transaction against its documentation, such as a deposit slip.

b. Verify totals for several departments.

c. Encode the dollar-amount field.

d. Mechanically endorse the back of the check.

e. Sort the items according to destination.

13.20 The flow of checks for collection depends primarily on the location of the institution on which the check is drawn. Processing an on-us check for deposit to another account in the same institution is straightforward: The

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[1] Interagency guidance issued by the OCC; Board of Governors of the Federal Reserve System, FDIC, OTS, and the NCUA, addresses the risks and accounting treatment associated with overdraft protection programs.

institution debits the check writer's account and credits the check depositor's account. Processing a check drawn on another depository institution, however, can be complex.

13.21 Though some direct collections are made in the banking system, most institutions collect foreign checks through a clearing arrangement (clearinghouse), a correspondent bank, or the Federal Reserve.

13.22 In a clearing arrangement, a group of depository institutions in a given area that receive large numbers of deposited checks drawn on one another meets to exchange and collect payment for the checks. Checks are physically exchanged among participants, and collection is made by crediting or debiting the net amount presented by each institution against all the others.

13.23 When a correspondent institution receives a check drawn on one of its respondent institutions, the check collection process can take several different routes. If the presented check is drawn on an institution that also maintains an account with the correspondent, collection simply involves the correspondent's transfer of deposit credit from one account to another account. If the check is drawn on an institution that does not have an account relationship with the correspondent, the check is credited to the respondent institution's account and then either (*a*) sent to a second correspondent in which the first correspondent and the institution on which the check is drawn both have an account, (*b*) sent to a local clearinghouse, or (*c*) sent to a Federal Reserve bank.

13.24 The Federal Reserve collects checks by internally transferring credit balances from one account to another, in much the same way that individual institutions collect on-us checks. For presenting and paying institutions that have accounts at two different Federal Reserve banks, an extra step is involved in the collection process. Each Federal Reserve bank has an interdistrict settlement account that it maintains on the books of the Interdistrict Settlement Fund established in Washington, D.C., to handle settlements. A check presented to one Federal Reserve bank drawn on a depository institution in another Federal Reserve district will result in a transfer of interdistrict settlement account balances from one Federal Reserve bank to another.

13.25 ***Electronic Funds Transfer (EFT) Systems.*** Institutions have responded to the large volume of checks and the high costs of clearing checks by increasingly using EFT systems. EFT systems are computer-based networks designed to move funds to and from accounts and to and from other institutions electronically, thus eliminating paper-based transactions. Banks and savings institutions transact an enormous volume of daily business between themselves and for customers over regional and national EFT systems. The three principal kinds of EFT systems are direct deposit systems, automated clearinghouse (ACH) systems, and ATMs.

13.26 A direct deposit system involves the direct deposit of payments into a customer's account without the use of a definitive check and is widely used for payrolls. The payment information is usually transmitted to the institution from the payer in electronic form and processed through the institution's proof system.

13.27 An ACH is used to transfer funds from one institution's account at a Federal Reserve bank to that of another; conduct transactions in the federal funds market; transfer funds for customers; transfer book entries representing certain securities; and receive, send, and control other specific EFT messages between member banks and other clearinghouses. The largest ACH is Fedwire, operated by the Federal Reserve. The Clearing House Interbank Payments System (CHIPS) is an ACH operated by the New York Clearing House Association and is the focal point for payments in the world's international dollars market. International dollar payments generally do not leave the United States but are held as deposits at money-center and regional banks or the U.S. branches of foreign banks and are transferred between accounts through CHIPS in payment for internationally traded goods and services, international financial transactions, or settlement of debt.

13.28 Institutions also provide a variety of retail EFT services, including ATMs, POS terminals, telephone bill payment, and home computer banking.

13.29 ***The Check Clearing for the 21st Century Act (Check 21).*** Check 21 requires financial institutions to recognize paper checks constructed from digital images as negotiable instruments (Subpart D of Regulation CC, Expedited Funds Availability). These negotiable instruments, known as *substitute checks*, must contain certain information to be considered a legal equivalent of an original check: To be a legal equivalent, substitute checks must:

a. Be suitable for automated processing.

b. Bear a MICR line containing all the information appearing on the original check.

c. Meet the technical requirements for substitute checks.

d. Bear a legend that states, "This is a legal copy of your check. You can use it the same way you would use the original check."

e. Be able to be processed in the same manner as the original check with current check processing equipment.

13.30 Check 21 includes necessary warranties, indemnities and disclosures. If a financial institution transfers, presents, or returns a substitute check for consideration (payment), it warrants that:

1. The substitute check has met all the requirements to have legal equivalence to the original check.
2. No party will be asked to pay a check that already has been paid.

Under these warranties, the financial institution will indemnify any person who suffered a loss due to the receipt of a substitute check instead of the original check. If the financial institution transferred a substitute check to a consumer who experienced a loss, it may be responsible for recrediting the consumer. Banks should have procedures in place for processing recredit amounts for consumer payment. Additionally, upon the implementation of Check 21, certain consumer disclosures explaining Check 21 are required to be sent to consumers.

13.31 Institutions are not required to initiate the substitute check process and are also not required to accept electronic check images or electronic check information as the legal equivalent of the original check or to participate electronic transfer exchange. With Check 21, financial institutions can convert paper checks into electronic images and deliver IRDs in place of the original for payment. Additionally, two banks or a network of multiple banks through mutual agreement can now exchange data taken from the MICR of the original check or an electronic image of the original check, and drastically reduce turnaround time.

Regulatory Matters

Limitations on Brokered Deposits

13.32 Restrictions on the acceptance of brokered deposits, particularly for institutions that become undercapitalized, could affect an institution's liquidity. The effect of such restrictions on liquidity may be a condition, when considered with other factors that could indicate substantial doubt about an entity's ability to continue as a going concern. (See Chapter 5, "Audit Considerations and Certain Financial Reporting Matters.")

13.33 ***Banks and Savings Institutions.*** Section 29 of the Federal Deposit Insurance (FDI) Act (codified in Title 12 of the Code of Federal Regulations [12 CFR] Part 337) significantly limits the acceptance or use of brokered deposits, funds which the reporting bank obtains directly or indirectly by or through any deposit broker for deposit into one or more accounts, by depository institutions other than those that are well capitalized (as defined for purposes of prompt corrective regulatory action, as discussed in Chapter 1, "Industry Overview—Banks and Savings Institutions"). Adequately capitalized institutions may accept brokered deposits only if they first obtain a waiver from the Federal Deposit Insurance Corporation (FDIC). Undercapitalized institutions are prohibited from accepting brokered deposits.

13.34 Section 29 of the FDI Act also limits the interest rates that may be offered by under- or adequately capitalized institutions. Undercapitalized institutions may not solicit any deposits by offering rates significantly higher (as defined) than prevailing rates. Adequately capitalized institutions are prohibited from paying interest on brokered deposits above certain levels.

13.35 ***Credit Unions.*** Section 107(6) of the Federal Credit Union Act (FCUA) (codified in Title 12 of the Code of Federal Regulations [12 CFR] Part 701.32(b)) limits the acceptance or use of nonmember and public unit deposits (as defined), including brokered deposits, to the greater of (*a*) 20 percent of the total deposits of the federal credit union or (*b*) $1.5 million.

Credit Union Confirmations

13.36 As discussed further in paragraph 13.55, supervisory committees of federal credit unions are required to perform a verification of member's accounts.

Accounting and Financial Reporting

13.37 Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*,[†] states that the institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. Checking accounts that are overdrawn should be

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[†] In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. This Statement revised language contained in paragraph 10 of FASB Statement No. 140. As a result, the language in SOP 01-6, paragraph 8(h), was revised to remove reference to paragraph 10(*b*) of FASB Statement No. 140. For additional information regarding FASB Statement No. 156. See paragraph 13.43.

reclassified as loans and should therefore be evaluated for collectibility as part of the evaluation of credit loss allowances.

13.38 SOP 01-6, paragraph 10(*c*), further states that checks that are deposited by customers and that are in the process of collection and are currently not available for withdrawal (deposit float) should be recorded as cash and deposit liabilities. Deposits should not be recorded based solely on collections.

13.39 SOP 01-6, paragraph 11(*d*), states that generally accepted accounting principles (GAAP) require that all member deposit accounts of credit unions, including member shares, be reported unequivocally as liabilities in the statement of financial condition.[2] The statement of financial condition either (*a*) presents deposit accounts as the first item in the liabilities and equity section or (*b*) includes deposit accounts within a captioned subtotal for total liabilities. An unclassified presentation whereby all liabilities and equity are shown together under one subheading and savings accounts are presented as the last item before retained earnings is not an acceptable presentation. The interest paid or accrued on these accounts, commonly referred to as "dividends," should be reported as an expense on the statement of income, and the amount of interest payable to members should be included as a liability in the statement of financial condition. This is the same position that the FASB Emerging Issues Task Force (EITF) reached in EITF Issue No. 89-3, *Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions*.

13.40 The Credit Union Membership Access Act (CUMAA) (H.R. 1151) was passed into law in August 1998. This legislation requires all federally insured credit unions with assets of $10 million and over to follow GAAP. Accordingly, all federally insured credit unions with over $10 million in assets are required to file their call report on a GAAP basis. However, the call report is not structured for GAAP presentation and disclosure and shows deposits in a separate category, not in equity or liabilities. To the National Credit Union Association (NCUA), the call report deals specifically with recognition and measurement for GAAP rather than presentation and disclosure.

13.41 Auditors who have issued qualified opinions in prior years for GAAP departures and are currently being requested to opine on financial statements that continue to show deposits as equity need to properly disclose the departure and the new regulations. Paragraph .52 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), describes the required disclosures in a qualified opinion resulting from a departure from a generally accepted accounting principle. (For a detailed discussion on reports issued under the guidance of AU section 508 and related PCAOB requirements when performing integrated audits, see Chapter 22 of this Guide.)

13.42 SOP 01-6 states that disclosures about deposit liabilities should include the following:

a. The aggregate amount of time deposit accounts (including CDs) in denominations of $100,000 or more at the balance-sheet date

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[2] FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, clarifies how an issuer classifies and measures certain financial instruments with characteristics of liability and equity. Paragraph 9 of FASB Statement No. 150 indicates that a mandatorily redeemable financial instrument issued in the form of shares shall be classified as a liability unless redemption is required to occur only upon the liquidation or termination of the reporting entity. Members' share accounts, which are demand deposits, must be reported as liabilities under FASB Statement No. 150.

b. Securities, mortgage loans, or other financial instruments that serve as collateral for deposits, that are otherwise not disclosed under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*[‡]

c. The aggregate amount of any demand deposits that have been reclassified as loan balances, such as overdrafts, at the balance-sheet date

d. Deposits that are received on terms other than those available in the normal course of business

e. The fair value of deposits (in conformity with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* as amended.)

13.43 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140.* The Statement amends paragraphs 35(c) and 40 of FASB Statement No. 140. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, prior to the adoption of this Statement.

13.44 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140.* Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

13.45 Some additional disclosures about deposits should generally include the following:

a. For time deposits having a remaining term of more than one year, the aggregate amount of maturities for each of the five years following the balance sheet date (in conformity with paragraph 10b of FASB Statement No. 47, *Disclosures of Long-Term Obligations*.)

b. The amount of deposits of related parties at the balance-sheet date (in conformity with FASB Statement No. 57, *Related Party Disclosures*.)

13.46 For deposits payable on demand or with no defined maturities, the fair value disclosed would be the amount payable on demand at the reporting date.

[‡] The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, expected to be finalized in the first quarter of 2007. In November of 2005 the FASB staff issued FASB Staff Position (FSP) FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*. This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

Auditing

Objectives

13.47 The primary objectives of auditing procedures for deposit liabilities are to obtain reasonable assurance that:

a. Financial statement amounts for deposit liabilities and related transactions include all deposit obligations of the institution and reflect all related transactions for the period.

b. Deposit liabilities and related income statement and balance-sheet accounts have been properly valued, classified, and disclosed in conformity with GAAP.

Planning

13.48 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements,[3] which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to deposits. The following factors related to deposits contribute to higher inherent risk:

a. Recurring and significant difficulties in reconciling exception items

b. A practice of permitting depositors to withdraw funds from their accounts before deposited checks have been collected by the institution

c. Introduction of new deposit products

d. Use of derivative instruments to hedge deposits

e. Significant changes in the amount and activity of previously inactive or dormant accounts

f. Significant increases in the number of closed accounts, especially near the end of a reporting period

g. Numerous accounts having instructions not to mail account statements to the depositor (*no-mail* accounts)

Internal Control Over Financial Reporting and Possible Tests of Controls[4]

13.49 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of

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[3] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

[4] See footnote 1 in Chapter 5 regarding the applicability of PCAOB Standards.

internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

13.50 In addition to the above, when performing an integrated audit of financial statements and internal control over financial reporting, in accordance with PCAOB standards, refer to AU section 319.97 (AICPA, *PCAOB Standards and Related Rules*) for a discussion on the extent of test of controls.[5] For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

13.51 Effective internal control (as it relates to financial reporting of deposits) should provide reasonable assurance that (*a*) deposits are accepted in accordance with management's established policies, (*b*) misstatements caused by error or fraud in the processing of accounting information for deposits are prevented or detected, and (*c*) deposits are monitored on an ongoing basis to determine whether recorded financial statement amounts require adjustment.

13.52 As stated above, the independent accountant should obtain an understanding of internal controls, including the control environment. Control activities that may contribute to a strong control environment may include:

- Policies and procedures approved by the board of directors and that include position limits for each type of deposit (including brokered deposits) and guidelines for setting the interest rates offered on deposits
- Segregation of duties between persons involved with the proof function, persons having access to cash, persons responsible for opening new accounts and issuing CDs or savings certificates, persons with responsibility for authorizing account adjustments, and persons with responsibility for posting information to the general ledger (Because many of the potential duty conflicts found in the deposits area also exist for cash, it is usually efficient to coordinate any assessment of segregation of duties in those two areas.)
- Reconciliation of subsidiary ledgers for deposit principal, accrued interest, and related accounts to the general ledger on a periodic basis
- Daily performance of a proof and transit operation with rejected or exception items segregated and individually reviewed (Examples of such items include activity in dormant accounts or customer overdrafts.)
- Designation by management of persons such as officers or supervisory employees, to be responsible for reviewing and approving

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[5] Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), provides further guidance.

unposted holdover items, overdrafts, return items, and status of inactive or dormant accounts

- Files, ledger cards, canceled checks, deposit tickets, signature cards, and unissued CDs and savings certificates safeguarded from unauthorized access (including dual control over and prenumbering of unissued certificates and official checks)
- Periodic depositor account statements mailed regularly (Returned statements are controlled, with follow-up on a timely basis.)
- Supervisory personnel designated by management to be responsible for periodically reviewing activity in employee accounts for unusual transactions
- EFTs subject to control procedures that:
    - — Segregate duties between employees who handle cash, balance EFT transactions, authorize EFTs, and post EFTs to deposit accounts.
    - — Require authorization for EFTs exceeding a depositor's available balance.
    - — Establish and maintain current, written agreements with all depositors making EFT requests, particularly for those customers who initiate EFT requests by telephone, modem, or other means not involving signed authorization. These agreements generally should be required to set forth the scope of the institution's liability and the agreed-upon security procedures for authenticating transactions (such as callbacks or passwords).
    - — Provide for the review of rejected transactions and the correction and reversal of entries by a supervisor.
    - — Restrict initiation of EFTs and access to computer terminals or other EFT equipment.
    - — Require that documentation of EFTs is provided to the parties involved on a timely basis.
    - — Disclose the name of the debit party to the receiver of funds.
    - — Provide for written instructions to employees and users concerning the EFT function.
    - — Provide for the use and confidentiality of authorized caller and other access codes or authentication algorithms, including periodic changes in such codes or algorithms.
    - — Provide for the maintenance of a current list of personnel authorized to initiate EFTs.
    - — Establish authorization limits for personnel.
    - — Provide for holds to be placed on customer accounts by EFT personnel when instructions are received directly from the authorized customer to confirm that available funds are in the customer's account or that the EFT funds are within authorized limits before the EFT is made.

  - Provide for the maintenance of card files or authorization letters on file for all customers who initiate EFTs.
- Controls and verification procedures over requests for EFTs in place at respondent depository institutions.

13.53 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Examples of tests of controls might include:

- Observe or otherwise obtain evidence about segregation of duties and supervisory review of activity in employee accounts.
- Test the reconciliations of related accounts, including the disposition of reconciling items and review and approval by a person other than the preparer.
- Test controls over origination of and access to signature cards and mailing address files.
- Test controls over the direct mailing of statements to depositors.
- Compare withdrawal slips with the applicable signature cards.
- Test controls over restrictions on deposits pledged as collateral, inactive or dormant accounts, and mail receipts.

13.54 Tests of control activities related to EFTs might include:

- Test compliance with management's established authorization and verification procedures.
- Validate sequence numbers on transfers sent and received.
- Confirm that acknowledgments are returned for all outgoing messages.
- Review management's daily comparison of the total number and dollar amount of EFTs sent and received with summaries received from the Federal Reserve.
- Test the reconciliations of daily reserve or clearing account statements for disposition of reconciling differences and supervisory review and approval.
- Test the procedures for identification and verification of EFTs with respondent institutions.
- Observe control activities that address access.

Substantive Tests

13.55 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to deposits.

13.56 Audit procedures for deposits should include testing the reconciliations of related subsidiary and general ledger accounts, confirmation of account balances, and analytical procedures.

13.57 ***Subsidiary Records and Reconciliations.*** Procedures should be performed that provide reasonable assurance that the subsidiary ledger information to be confirmed and tested has been recorded properly in the general ledger. The disposition of reconciling items between general and subsidiary ledgers (such as returned items, adjustment items, holdovers, overdrafts, and service charges) might be investigated to determine whether any adjustments to recorded amounts are necessary.

13.58 ***Confirmations.*** Guidance on the extent and timing of confirmation procedures is found in AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), and AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1). Guidance on planning, performing, and evaluating samples is included in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1). The auditor should design and perform further audit procedures that are responsive to the assessed risk of material misstatement. Confirmation of deposits provides evidence about existence and accuracy. Although independent accountants may be more concerned with the completeness of recorded deposits, the independent accountant should perform other substantive procedures to satisfy other relevant assertions. It would be appropriate for the independent accountant to use the negative form of confirmation request only when the risk of material misstatement is low and the independent accountant has no reason to believe that the recipients will not consider the requests. See AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), for additional guidance. If confirmations are used, active, inactive, and dormant accounts, and accounts closed during the period, should all be included in the population subject to audit procedures.

13.59 Some depositors may have instructed the institution not to send account statements to the depositor's mailing address. For such no-mail accounts, the independent accountant should review a written request from the depositor requesting the no-mail status and should use alternative procedures to obtain adequate evidence about the account balance. No-mail accounts and accounts for which confirmation requests are returned undelivered should be subjected to alternative procedures (such as personal contact with the depositor). (See paragraphs .31 and .32 of AU section 330 for additional guidance.)

13.60 ***Credit Union Supervisory Committee Procedures.*** It should be noted that one of the explicit duties of a federally insured credit union's supervisory committee is to periodically perform a verification of the members' accounts. In addition to procedures required under GAAS, auditors may be asked to extend their procedures to assist in meeting the supervisory committee's requirements. Section 701.12(e) of the NCUA's Rules and Regulations require that the verification be made using any of the following methods:

- A controlled verification of 100 percent of members' share and loan accounts
- A sampling method that provides a random selection that is expected to be representative of the population from which the sample was selected, which will allow the auditor to test sufficient accounts in both number and scope to provide assurance that the general ledger accounts are fairly stated in relation to the financial statements taken as a whole (That sampling procedure must provide each dollar in the population an equal chance of being selected.)

- For independent, licensed, certified public accountants, the additional option of sampling members' accounts using nonstatistical sampling methods consistent with applicable GAAS provided the sampling method provides a selection that allows the auditor to test sufficient accounts in both number and scope to provide assurance that the general ledger accounts are fairly stated in relation to the financial statements taken as a whole (Independent, licensed, certified public accountants will be responsible for documenting their sampling procedures, and providing evidence to NCUA, if requested, that the method used is consistent with applicable generally accepted auditing standards.)

13.61 ***Check 21.*** Below are some potential audit concerns that may arise related to Check 21.

- The auditor will see fewer original checks as they are replaced by substitute checks. The auditor should understand what the financial institution will be disseminate and return during processing, and accordingly adjust their audit planning.
- Detecting check fraud may become more difficult as substitute checks will no longer contain watermarks, fingerprints, ink or original paper with access to pressure points. Since the original check is no longer used for processing, the security of the electronic systems will reduce human access to the financial information and reduce employee fraud or error. Shorter processing time will allow for a quicker identification of check fraud or forgery.
- The financial institution may have purchased equipment that does not have the proper controls in place to prevent computer hacking, due to, unnecessary pressure from outside vendors for the implementation of Check 21 before being able to evaluate and ensure system security and quality.
- Financial institutions may not have implemented the proper procedures to expedited recredits, or provided answers to consumers' questions on the role of substitute checks, substitute check rights, and the Consumer Awareness Disclosure.

13.62 ***Accrued Interest Payable, Interest Expense, and Service Charge Income.*** Audit procedures should be performed on accrued interest payable, interest expense, and service charge income in connection with other procedures on deposits. Audit procedures for such amounts include reviewing and testing reconciliations of subsidiary ledgers with the general ledger, recalculating interest paid, accrued interest payable, and service charge income, and testing of interest expense and service charge income for the period.

13.63 ***Overdraft Protection Programs.*** Audit procedures on overdraft protection programs may include verifying that overdraft balances are properly classified along with the related write-offs of uncollectible balances.

13.64 ***Other Analytical Procedures.*** Analytical review procedures can provide substantive evidence about the completeness of deposit-related financial statement amounts and disclosures; however, such procedures in tests of deposit expense are often less precise than substantive tests such as recalculations. Because institutions generally offer a wide variety of deposit products and rates (which change frequently during a financial reporting period), it is normally difficult to develop expectations to be used in analyzing yields on deposits.

Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision. Further guidance is provided in AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), and AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1). The independent accountant should be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends should be considered to determine if the institution's trend appears reasonable. Some analytical review procedures that should be considered include:

- Compare the percentage of deposit growth during the period with historical percentages.
- Compare the average deposit account balances during the period with those of prior periods.
- Review the relative composition of deposits from period to period.
- Compare the amounts and percentage ratio of dormant accounts to total deposits with those of prior periods.
- Compare deposit interest rates with those prevailing in the institution's marketing area for the same periods.

13.65 When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

13.66 For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

Chapter 14

Federal Funds and Repurchase Agreements[*]

Introduction

14.01 This chapter addresses two types of transactions—federal funds and repurchase agreements (repos)—that can be either investing or financing transactions, depending on which side of the transaction the financial institution participates. Federal funds transactions can be an important tool for managing liquidity. Repos also can provide a cost-effective source of funds and may provide a means for the institution to leverage its securities portfolio for liquidity and funding needs.

Federal Funds Purchased

14.02 Federal funds are funds that commercial banks deposit at Federal Reserve Banks. Banks must meet legal reserve requirements on a daily basis by maintaining a specified total amount of deposits at Federal Reserve Banks and vault cash. A bank with excess reserves on a particular day may lend the excess, at an agreed-rate of interest (the federal funds rate), to another bank needing funds to meet its reserve requirements that day. The federal funds market does not increase or decrease total reserves in the Federal Reserve System, but merely redistributes them to facilitate efficient use of bank reserves and resources. However, by setting reserve requirements, the Federal Reserve may increase or decrease total reserves in the system. No physical transfer of funds takes place; the Federal Reserve Bank charges the seller's reserve balance and credits the buyer's reserve balance. In addition to buying and selling funds to meet their own needs, banks with correspondent banking relationships absorb or provide funds as a service or accommodation to their correspondents. Accordingly, banks may operate on both sides of the federal funds market on the same day.

14.03 Two types of transactions involving federal funds are commonly used. In an unsecured transaction, the selling bank sells federal funds on one day and is repaid with interest at maturity (usually the next day). In a collateralized transaction, other than by a repo, a bank purchasing federal funds places U.S. government securities in a custody account for the seller until the funds are repaid. A borrowing bank records a liability (federal funds *purchased*) and a selling bank records an asset (federal funds *sold*).

Repurchase Agreements[1]

14.04 An institution that sells securities and agrees to repurchase the identical (or substantially the same) securities at a specified date for a specified

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] Paragraphs 14.23 and the following address whether, for accounting purposes, certain transfers of securities are considered sales or secured borrowings.

price has entered into a repurchase agreement, or repo,[2] as a seller-borrower. Alternatively, an institution may participate as a buyer-lender by agreeing to purchase and resell at a specified future date for a specified price. Most repos involve obligations of the federal government or its agencies, but other financial instruments, such as commercial paper, banker's acceptances, and negotiable certificates of deposit (CDs), are sometimes used in repos. Repos are similar to the seller-borrower's borrowing funds equal to the sales price of the related securities with the securities as collateral. The difference in the price at which the institution sells its securities and repurchases them represents interest for the use of the funds. Most repo transactions occur with other depository institutions, dealers in securities, state and local governments, and customers (retail repurchase agreements). Maturities of such agreements are flexible and generally vary from one day to 270 days.

14.05 Dollar repurchase agreements (also called *dollar rolls*) are agreements to sell and repurchase similar but not identical securities. The dollar roll market consists primarily of agreements that involve mortgage-backed securities (MBSs). Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and generally have different principal amounts. The most common types of dollar rolls are fixed-coupon and yield-maintenance agreements.

14.06 In a fixed-coupon agreement, the securities repurchased have the same stated interest rate as, and maturities similar to, the securities sold and are generally priced to result in substantially the same yield. The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk.

14.07 In a yield-maintenance agreement, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.[3] The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield-maintenance agreements may contain *par cap*[4] provisions that could significantly alter the economics of the transactions.

14.08 The terms of the agreements often provide criteria to determine whether the securities are similar enough to make the transaction, in substance, a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. For agreements involving securities collateralized by dissimilar pools, those transactions are accounted for as sales and purchases of securities.

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[2] Broker-dealers and this Guide refer to agreements by seller-borrowers to sell and repurchase securities as repurchase agreements (repos) and agreements by buyer-lenders to purchase and resell securities as reverse repurchase agreements (reverse repos). Savings institutions and credit unions have in the past used the opposite terms, calling a seller-borrower's agreement a *reverse repurchase agreement* and a buyer-lender's agreement a *repurchase agreement*.

[3] The price-spread relationship between securities with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

[4] A *par cap* provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed-coupon agreements do not contain par cap provisions.

14.09 ***Rollovers and Extensions.*** Occasionally, securities involved in repos are not delivered on the settlement date of the agreement and the contract may be rolled over or extended upon mutual agreement of the buyer-lender and seller-borrower.

14.10 ***Breakage.*** Securities repurchased under repos commonly have a principal amount that differs from the principal amount of the security originally sold under the agreement. This is particularly common to dollar rolls, which involve MBSs. That difference is referred to as breakage and occurs because the principal amounts of MBSs generally differ as a result of the monthly amortization of principal balances of mortgages collateralizing the MBSs. The amount of the breakage is a factor in determining whether substantially the same security is reacquired in the repo transaction, that is, whether good delivery (one in accordance with the agreement terms) has been met on repurchase of the MBSs.

14.11 ***Business Risk.*** Business risks associated with repos include the contractual and economic complexities inherent in certain of these transactions and the corresponding risk associated with the degree to which the institution's management understands the terms of the agreements and the economics of the transactions. Misunderstandings may result in incorrect pricing of the agreements or an incorrect assessment of the risks that are being assumed, the return that is anticipated to be earned, or the financing costs that are being incurred. Misunderstandings of the terms may also result in improper accounting treatment of the transaction (that is, as a sale and purchase or as a secured borrowing).

14.12 ***Market Risk.*** The prices of government securities vary inversely with changes in interest rates. Price changes may be small, but they can result in significant changes in the market values of government securities due to the large dollar amounts often involved in government securities transactions. This is generally referred to as *market risk*. Price changes may affect the ability of the seller-borrower under repos to continue the financing without providing additional collateral. Changes in prices also affect the margin in a transaction and may create a need for the seller-borrower to transfer additional securities or return cash.

14.13 The excess of the market value of the securities transferred by the seller-borrower over the amount of cash transferred by the buyer-lender is called a *haircut*. A haircut represents a margin of safety required by the buyer-lender to guard against a decline in the value of the collateral as a result of rising interest rates during the term of the agreement. Whether an agreement provides for a haircut depends on competition among buyer-lenders and seller-borrowers and their relative bargaining strengths. Haircuts generally range from a fraction of one percent to four percent or five percent but may be higher in certain instances.

14.14 All of the following factors are considered in determining the haircut for a particular transaction:

a. The term of the agreement

b. The creditworthiness of the institution

c. The type of securities underlying the agreement, the length of time to maturity, and the creditworthiness of the issuer of the securities *d.* The volatility of the market value of the underlying securities

e. The differential between the interest rate specified in the agreement and the interest rate on the securities

14.15 ***Credit Risk.*** A repo or reverse repo can be considered a loan of cash by one party and a loan of securities by another. When the agreement is completed, both loans are repaid. Parties to repo and reverse repo transactions are subject to credit risk, that is, the risk that the transaction counterparty will not perform under the terms of the agreement. For example, a seller-borrower is at risk that changes in market prices and resulting economic losses may prevent the buyer-lender from returning the securities at the maturity of the agreement.

14.16 Credit risk also exists to the extent that the issuer of the underlying securities may default. However, such risk may be negligible for securities issued or guaranteed by the U.S. government or its agencies. If the issuer of the underlying securities defaults, both participants in the repo are obligated to complete the transaction. This aspect of credit risk is affected by the extent to which the institution's repo position is concentrated in any one type of underlying security or with any one counterparty.

14.17 The extent of credit risk faced by a seller-borrower also depends on the buyer-lender's business policies and practices for control and use of collateral, the extent of the haircut on securities serving as collateral, the extent to which the buyer-lender offsets transactions (that is, maintains a matched book), and the buyer-lender's extent of capitalization.

14.18 Analyzing credit risk requires an understanding of how securities dealers and other counterparties to repos manage their businesses and of the steps that can be and are taken to reduce their exposure to market risk. Securities dealers are typically highly leveraged, with securities positions that represent large multiples of their net capital and that can quickly be eroded by adverse market changes. Many securities dealers entering into repos frequently employ matched-book transactions. In a matched-book transaction, the securities dealer effects both a repo and a reverse repo with the same underlying securities for the same period of time but usually at slightly different rates. By running a matched book, a dealer can reduce its exposure to market changes, and a seller-borrower may face less credit risk by entering into agreements with a dealer that has a matched book and employs adequate procedures to control credit risk. Even if the dealer runs a matched book, the seller-borrower still faces credit risk associated with the dealer's credit risk, that is, the risk that a customer of the dealer might not be able to complete its agreement with the dealer.

14.19 ***Risk of Collateral Loss.*** When an institution transfers the securities sold under an agreement to repurchase, there is a risk that the dealer may not be able to reverse the transaction by selling the securities back at the agreed price. If the institution overcollateralizes the agreement by selling the securities at a relatively large discount from the market price, its rights to the overage may be diminished or lost entirely in the event of the dealer's bankruptcy. In that case, the institution may find that neither the securities nor the funds to replace the securities are available for the dealer to complete the transaction and, as a result, may incur an economic loss. If the institution does not have the legal right of setoff, the potential economic loss extends to the full value of the securities, including accrued interest.

14.20 If the institution has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited to the excess of the market value of the securities, plus accrued interest, at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest. However, the accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value. (See paragraph 14.30.)

14.21 Securities purchased under agreements to resell (reverse repos) pose risk to buyer-lenders to the extent that they do not take possession of the securities they agreed to resell.[5] If the buyer-lender or securities dealer through whom the transaction is made does not perfect a security interest in securities purchased (by having signed an agreement and by taking possession, either directly or through a custodian acting as its agent), the potential economic loss extends to the full value of the securities and the risk assumed—namely, credit risk—becomes that of an unsecured lender. Institutions reduce such risk by:

a. Making sure that definitive collateral is held by the counterparty's custodian as the counterparty's agent with specific identification of the assignee

b. Settling through the Federal Reserve System, where book-entry collateral is transferred directly or by a notation entry

c. Evaluating the creditworthiness of the other party to the agreement

d. Overcollateralizing the borrowing

Regulatory Matters

14.22 In 1985, the Federal Financial Institutions Examination Council (FFIEC) issued a policy statement that was adopted by the Office of the Comptroller of the Currency (OCC), FRB, and Federal Deposit Insurance Corporation (FDIC). The policy established guidelines for insured depository institution repurchase agreement activities including guidelines for written repurchase agreements, policies and procedures, credit risk management, and collateral management. The Office of Thrift Supervision (OTS) has not separately adopted the policy statement, but refers federal savings associations to the FFIEC policy statement. In 1998, the FFIEC modified the policy statement to reflect the enactment and inclusion of other laws and regulations applicable to repurchase agreements and to update the list of written repurchase agreement provisions with an expanded list of provisions to reflect current market practice.

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[5] The SEC issued Regulation B, which delineates the securities activities banks may engage in without registering as a broker under the Securities Exchange Act of 1934. The rule primarily affects:

1. banks that handle securities transactions either as a custodian or as a fiduciary;
2. banks that have fiduciary accounts, such as trust accounts, that invest in mutual funds that pay the bank fees in conjunction with a plan authorized under the SEC's Rule 12b-1;
3. banks that offer securities through networking arrangements with registered broker-dealers; and
4. banks that enter into sweep account programs using money market funds. Banks not falling under the umbrella guidelines must register with the SEC as a broker or delineate broker activities to registered affiliates or third-party brokerage firms (www.sec.gov/rules/proposed/34-49879.htm).

Accounting and Financial Reporting

14.23 As discussed beginning in paragraph 7.78, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,[6] provides accounting and reporting standards for transfers of financial assets, including repurchase transactions. Paragraphs 96 through 98, 100, and 101 provide implementation guidance for accounting for repurchase agreements.

14.24 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statement No. 133 and 140*. The Statement amends paragraphs 35(c) and 40 of FASB Statement No. 140. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

14.25 In March of 2006, the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

14.26 Paragraph 98 of FASB Statement No. 140 says:

> If the criteria in paragraph 9 [of the Statement] are met, the criterion in paragraph 9(c)(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

14.27 Paragraph 15 of the Statement addresses the accounting for collateral transferred in secured borrowing transaction. It states that a debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations may also grant a security interest in certain assets to the secured party. If collateral is transferred to the secured party, the custodial

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[6] The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, expected to be finalized in the first quarter of 2007. Readers should monitor developments on this proposal. In November of 2005 the FASB staff issued FASB Staff Position (FSP) FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*. This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur under different names in transfers documented as sales that are accounted for as secured borrowings. The accounting for non-cash collateral by the debtor (or obligor) and the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

14.28 Paragraph 100 of the Statement notes that, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. (Paragraphs 47 through 49 of FASB Statement No. 140 provide guidance on determining whether an agreement maintains effective control over transferred assets.) Paragraph 100 says that repurchase agreements that do not meet all the criteria in paragraph 9 of FASB Statement No. 140 should be treated as secured borrowings.

14.29 Paragraph 47 of FASB Statement No. 140 says an agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets under paragraph 9(C)(1), and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48 of the Statement gives related guidance [paragraph 14.30 herein]).

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49 of the Statement [paragraph 14.31 herein]).

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into concurrently with the transfer.

14.30 Paragraph 48 of FASB Statement No. 140 says that, to be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)[7]

b. Identical form and type so as to provide the same risks and rights[8]

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)[9]

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[7] The exchange of pools of single-family loans would not meet this criterion, because the mortgages making up the pool do not have the same primary obligor and would therefore not be considered substantially the same.

[8] For example, this criterion would not be met by the Government National Mortgage Association (GNMA or Ginnie Mae) I securities for Ginnie Mae II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

[9] For example, the exchange of a *fast-pay* Ginnie Mae certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a *slow-pay* Ginnie Mae certificate would not meet this criterion, because differences in the expected remaining lives of the certificates result in different market yields.

d. Identical contractual interest rates

e. Similar assets as collateral

f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved[10]

14.31 Paragraph 49 of FASB Statement No. 140 says that, to be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

14.32 ***Offsetting.*** Financial institutions may operate on both sides of the federal funds and repo markets on the same day. Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion 1966*, paragraph 7, says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a *right of setoff* exists. "FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to permit offsetting. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, modifies FASB Interpretation No. 39 to permit offsetting in the statement of financial position of only payables and receivables that represent repos and reverse repos that meet all of the conditions specified therein and does not apply to securities borrowing or lending transactions.

14.33 As discussed in paragraph 7.108 of this Guide and paragraph 17 of FASB Statement No. 140, as amended by FASB Statement No. 156, requires certain disclosures about transfers and the servicing of financial assets. Paragraph 17a, requires an entity that has entered into repurchase agreements or securities lending transactions to disclose its policy for requiring collateral or other security.

14.34 ***Fair Value Disclosures.*** FASB Statement No. 107, *Disclosures about Fair Value of Financial Assets*, as amended, requires disclosures of the fair values of all financial instruments for which it is practicable to estimate fair value. In addition, FASB Statement No. 107 requires disclosure of significant concentrations of credit risk arising from all financial instruments.[11] The concentrations-of-credit-risk disclosures apply to debt securities and loans. The carrying amounts of repos and reverse repos maturing within 90 days generally would approximate their fair values. Under FASB Statement No. 107, quoted

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[10] Participants in the MBS market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by the PSA.

[11] FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment to FASB Statement No. 107*, as amended, amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to make disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

market prices should be used to estimate fair values. If quoted market prices are not available, quoted market prices and prevailing interest rates of financial instruments with similar characteristics should be used to estimate fair value.

Auditing

Objectives

14.35 The primary objectives of audit procedures applied to federal funds and repo transactions are to obtain reasonable assurance that:

a. The reported amounts include all federal funds purchased or sold and that repos and reverse repos are properly identified, described, and disclosed; include all such agreements; and are stated at appropriate amounts.

b. Interest expense or income and the related balance-sheet accounts are properly measured and reported in the proper periods.

c. Repos and dollar rolls accounted for as secured borrowings meet the criteria for secured borrowings, including the condition that the assets to be repurchased or redeemed are the same or substantially the same as those transferred.

d. Federal funds and repo transactions have been executed in accordance with management's authorizations and are obligations of the institution.

e. Assets pledged as collateral for federal funds and repo transactions are properly disclosed in the financial statements.

f. The federal funds sold and securities purchased under reverse repos exist and are either on hand or are held in safekeeping or custody for the bank.

g. The institution has legal title or similar rights of ownership for all recorded securities.

h. Recorded amounts include all such assets owned by the institution, and the financial statements include all related transactions during the period.

i. The values at which securities are reported are appropriate.

j. Realized and unrealized gains and losses on sales of securities are properly measured, recorded, and disclosed.

k. Securities involved in such agreements are properly described and classified in the financial statements and the related note disclosures are adequate.

Planning

14.36 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements[12], which are described in Chapter 5, "Audit Considerations

[12] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

and Certain Financial Reporting Matters," as they relate to the relevant assertions. Federal funds transactions are fairly routine for most institutions, are generally not complex, and many have matured by the close of the audit; thus, less risk may be associated with this account balance at a specific institution. Normal auditing procedures for borrowed funds could be applied to such obligations. However, certain repo transactions, whether viewed from an accounting, legal, or economic perspective, are extremely complex. Also, the risks involved in repo transactions vary widely, depending on the terms of the agreement, the parties involved, and the legal status of the agreement. The risks faced by an institution entering into a repo are generally reduced if the institution maintains effective controls related to the authorization, processing, and recording of these transactions. The auditing guidance in this chapter focuses on repo transactions.

14.37 The independent accountant should inspect the current-year's interim financial statements, board of directors' reports and minutes, supervisory examination reports or related reports, and pertinent financial information and accounting to obtain an understanding of the level of activity in federal funds and repos, types of transactions entered into, accounting treatment (financing versus a sale and repurchase), and compliance with the institution's established investment and asset/liability management policies.

14.38 The independent accountant should be aware that when the institution concentrates its repos with one dealer or a small group of dealers, the evaluation of credit risk and counterparty risk assumes particular importance. The independent accountant should:

a. Obtain an understanding of the institution's controls over evaluating the reputation and financial strength of the dealer.

b. Inspect the latest audited financial statements of the dealer.

c. Obtain an understanding of the specific entity within an affiliated group with which the institution is doing business.

d. Obtain an understanding of transactions between that entity and its affiliates.

14.39 The audit procedures applied to federal funds purchased and securities sold under agreements to repurchase are also appropriate for federal funds sold and securities purchased under agreements to resell. However, the independent accountant should also be aware that, as a buyer-lender, an institution might not take delivery of the securities that serve as collateral in a repo transaction. If it does take delivery, either directly or indirectly through another party acting as its agent, credit risk is less than may otherwise be the case; the independent accountant should consider confirming the occurrence and terms of the transaction, and the seller-borrower's obligation to repurchase the securities with the seller-borrower, and should consider counting securities in the institution's possession and confirming securities not in its possession with the custodian.

14.40 Whenever a buyer-lender or its agent does not take delivery of the securities, the independent accountant should consider confirming not only the occurrence and terms of the transaction and the obligation to repurchase the securities but also that they have not been delivered and are being held on the institution's behalf. The independent accountant should also recognize that, when delivery is not made, the transaction has many of the attributes of an unsecured loan. Accordingly, the independent accountant should consider assessing the reputation and financial strength of the seller-borrower and of its custodian. Based on those assessments, the independent accountant should consider the desirability of obtaining a report from the custodian's independent accountant on the custodian's internal accounting controls over securities held in safekeeping, about which AU section 324,[13] *Service Organizations* (AICPA, *Professional Standards*, vol. 1), provides guidance. The report should cover both the design of the system and compliance tests directed to specific objectives of internal accounting control over the custodial function.

Internal Control Over Financial Reporting and Possible Tests of Controls[14]

14.41 AU section 314 establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

14.42 In addition to the above, when performing an integrated audit of financial statements and internal control over financial reporting, in accordance with PCAOB Standards, refer to paragraph .95 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), for a discussion on the extent of test of controls. Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), provides further guidance. For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

14.43 The independent accountant should obtain an understanding of the institution's internal control over financial reporting of federal funds and repo transactions. (Chapters 7, "Investments in Debt and Equity Securities," and 15, "Debt," discuss related control issues for investments and borrowings, respectively.) Examples of controls in this area are as follows:

- The institution has formal, written policies that specify the types of securities that can be sold or repurchased under repos.

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[13] The AICPA Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*, includes illustrative control objectives as well as three interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

[14] See footnote 1 in Chapter 5 regarding the applicability of PCAOB Standards.

- Formal policies and procedures are in place to provide that repo transactions are executed in accordance with written contracts that describe the rights and obligations of the parties.
- Master agreements used by the institution should be entered into by authorized personnel and should specify the terms of the transactions and the intent of the parties.
- Only board-approved securities dealers and other institutions are allowed to enter into transactions with the institution.
- The institution has policies and procedures to provide that only authorized individuals enter into and approve such transactions and that those individuals are aware of the inherent risks and returns of such agreements. The institution's board of directors sets limits on the amount and terms of agreements with particular securities dealers and other institutions.
- The institution has policies and procedures for monitoring the reputation, financial stability, and creditworthiness of securities dealers and other institutions with which the institution may enter into an agreement as a basis for evaluating their ability to fulfill their obligation to return the collateral to the institution.
- The institution has procedures for monitoring communications with securities dealers and other institutions and for reviewing confirmations from securities dealers to detect unrecorded or inappropriately recorded transactions and to determine the reasonableness of interest rates.
- Initial transactions and rollover agreements are reviewed by a responsible official who determines whether the transactions represent sales or financing transactions.
- Written policies require frequent evaluation of the market value, including accrued interest, of the agreements and required collateral levels.
- The subsidiary ledgers containing information on securities collateralizing agreements are periodically reconciled to the general ledger.
- Policies and procedures exist to monitor the use of hedging techniques, if any, to reduce market risk.

14.44 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Examples of tests of controls the independent accountant may perform include the following:

- Obtain and review the institution's written investment and asset/liability management policies (or other applicable policies relating to the management of federal funds and repo transactions), and consider whether such policies have been reviewed and approved by the institution's board of directors.
- Obtain the institution's approved list of counterparties to agreements, and compare the list with those dealers with whom borrowing transactions were entered into during the current year.

Ascertain that counterparty limits set by the board of directors have not been exceeded.

- Review selected transactions to consider whether all significant terms were specified and documented and whether the amounts and terms were consistent with those established by the institution's formal investment and asset/liability management policies.
- Review supporting documentation for transactions, and consider whether only authorized individuals entered into or otherwise executed those transactions on behalf of the institution.
- Test whether the institution has properly followed procedures for recording the difference between the selling price and repurchase price as interest expense and whether interest expense is properly recorded on other borrowings, such as federal funds purchased.[15]
- Review the latest audited financial statements of the counterparties and other available reports, such as reports on internal control or special-purpose reports by the dealer's accountant, to determine whether the dealer has net capital in excess of statutory requirements.

14.45 If there is reason to question the creditworthiness of the counterparty, the independent accountant should consider consulting with legal counsel regarding whether, in the event of the counterparty's inability to return (sell back) the collateral securities, the institution has the right to set off the loan liability against the collateral.

Substantive Tests

14.46 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to federal funds and repurchase agreements.

14.47 ***Inspection of Repo or Other Documentation of Borrowing.*** Repos and other source documents should be inspected by the independent accountant and relevant details should be agreed upon as to the respective recording of the liability in the subsidiary records. The independent accountant should consider testing that securities collateralizing the borrowing are adequately identified to ensure proper disclosure, and the amounts and description should be agreed to the respective subsidiary ledger.

14.48 ***Confirmation.***[16] The independent accountant should consider confirming the amount and all significant terms of federal funds and repos with the respective securities dealers, customers, and institutions. Details of any rollovers or extensions of repos should be agreed to brokers' advices. Confirming the repo transactions provides evidence of the occurrence of the transactions, their terms, and the treatment of the underlying securities, for example, evidence that the securities were delivered to the counterparty; confirmation does not provide evidence about the existence, location, or transferability of the securities or about the counterparty's ability to complete the transactions. It is

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[15] These procedures also could be performed to provide substantive evidence.

[16] For additional guidance refer to AICPA Interpretation No. 1 "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 and Interpretation No. 1 "Auditing Investments in Securities Were a Readily Determinable Fair Value Does Not Exist," of AU section 332, respectively.

usually impracticable to confirm the location of the securities delivered to the counterparty as collateral. The counterparty often is not able to determine the exact location of the securities delivered because they are fungible with other securities of the same issue under the dealer's control and are commingled with those securities. In addition, the counterparty may have appropriately used the securities for collateral in another repo or dollar roll in which the counterparty sold the securities to be repurchased at a later date. The seller-borrower and its independent accountant need not necessarily be concerned, however, about the location of securities transferred to the counterparty as collateral because their location does not necessarily affect the risk that the counterparty may not complete the transactions.

14.49 The independent accountant should consider the need to assess the counterparty's ability to complete the transaction by other procedures, such as testing the subsequent completion of the transaction, reviewing audited financial statements of the counterparty, considering the regulatory requirements applicable to the counterparty, and, if necessary, obtaining a special-purpose report from the counterparty's independent accountant.

14.50 ***Review of Related-Party Transactions.*** The independent accountant should consider reviewing borrowing transactions involving related parties that have been accounted for as sales transactions to determine whether there are potential unrecorded financing transactions. A review of transaction activity may indicate that an event accounted for as two separate transactions (a sale and subsequent purchase) is in fact a repo that should be accounted for as a financing. The independent accountant should be alert for related-party transactions that are improperly accounted for, possibly to avoid recognizing losses on sales.

14.51 ***Assess Collateral Risk.*** The independent accountant should assess the collateral risk through consideration of the counterparty's reputation, financial position, and market presence. The independent accountant should review the current market values, including accrued interest, of securities serving as collateral and consider whether the collateral is sufficient or excessive in relation to the requirements of the agreement. Further, the independent accountant should assess whether those securities repurchased under repos meet the substantially-the-same criteria for financing transactions or whether a gain or loss should have been recorded under a sales transaction. Also, the independent accountant should test whether collateral held should be recognized on the balance sheet in accordance with FASB Statement No. 140. Under Paragraph 15 of FASB Statement No. 140, collateral transferred in a secured borrowing is recognized as an asset by the secured party only if the debtor (i.e., the transferor of collateral) defaults.

14.52 ***Analytical Procedures.*** Chapters 7 and 15 discuss analytical procedures that may also be applied in this area.

14.53 ***Tests of Fair Value Disclosures.*** The independent accountant should test the institution's fair-value disclosures by referring to the quoted market prices or prevailing interest rates of the same or similar instruments to evaluate whether the estimates are reasonable. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and equity presented or disclosed at fair value in financial statements. AU section 332, *Auditing Derivative Instruments, Hedging*

Activities, and Investments in Securities (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities that are made in an entity's financial statements.

14.54 ***Other Procedures.*** Other audit procedures related to repos that the independent accountant may consider performing are as follows:

- Read the board of directors' minutes to determine whether financing transactions have been authorized.
- Test whether approved securities dealers are used, and whether financing arrangements comply with the institution's established policies.
- Recompute gains or losses on reverse repos that are not accounted for as secured borrowings on a test basis.

Chapter 15

Debt*

Introduction

15.01 Depository institutions use long- and short-term borrowings to provide funds that supplement deposits and to carry out their overall asset/liability management strategy. Finance and mortgage companies cannot take deposits, and therefore, rely almost exclusively on borrowings to fund loans and operations.

15.02 Debt-to-equity ratios of finance companies generally are higher than those of manufacturing companies because finance company assets consist more of liquid receivables than of inventories and fixed assets. Debt-to-equity ratios of at least four- or five-to-one are not uncommon for finance companies. However, finance companies' leverage has traditionally been much lower than the leverage of depository institutions.

15.03 Debt may be classified as senior, senior subordinated, and junior subordinated. The classifications describe declining priorities, which become especially significant when solvency becomes questionable.

15.04 Company policy and credit rating goals cause companies to establish diverse target amounts for each priority category of debt. Moreover, debt agreements usually contain restrictions on the amount of debt that may be incurred in each category. For example, a common restriction in debt securities issued to the general public prohibits pledging assets to secure new or existing debt. Other common restrictions may limit dividend payments and the amount of additional senior debt that can be incurred. If an issuer has other restrictions in its current typical public issue, lenders commonly demand the same restrictions in a private placement.

15.05 The creditworthiness of an institution's debt may be assessed by a rating agency based on analysis of ratios and other factors.[1] Ratings directly affect the institution's cost of borrowing and, thus, its ability to borrow. Institutional investors, such as other financial institutions, insurance companies, trusts, mutual funds, and pension and profit-sharing plans, rely heavily on credit ratings when making investment decisions. Some are prohibited by law or formal agreement from investing in debt below a specified minimum level. For example, some states prohibit licensed domestic insurance companies from investing in corporate obligations that do not meet specified fixed-charge coverage ratios. Similarly, many government agency pension funds are prohibited by law from investing in securities that do not have an investment grade rating.

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* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] For example, many debt agreements consider the debt in default if the issuer fails to pay interest. Accordingly, credit risk may be assessed (in part) through analysis of fixed-charge coverage, which is the ratio of pretax earnings (before interest expense) to interest expense.

Long-Term Debt

15.06 The most common long-term debt funding sources are debentures and notes. Institutions also may have long-term mortgages, obligations and commitments under capital leases, and mandatorily redeemable preferred stock, which have many of the characteristics of debt. Such obligations are similar to those of other kinds of enterprises. Funds are also borrowed through Eurodollar certificates, collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs), mortgage-backed bonds (MBBs), mortgage-revenue bonds, and Federal Home Loan Bank (FHLB) advances.

15.07 The terms of an institution's long-term debt obligations vary widely. They may be secured or unsecured. The debt may be senior or subordinated to other debt. The debt may be convertible into shares of common stock. Convertible debentures are convertible into stock at a specified price at the option of the holder. In most cases, convertible debt securities are also callable at the option of the issuer, generally beginning a few years after issuance. Interest rates may be fixed or floating.

15.08 Credit unions may borrow from individuals (whether or not they are members of the credit union) by issuing promissory notes or *certificates of indebtedness*. Certificates of indebtedness are generally uninsured. Their issuance is governed by Section 701.38 of National Credit Union Administration (NCUA) *Rules and Regulations*. Credit unions can have access to the NCUA maintained Central Liquidity Facility for short term borrowing by either being a member directly, or indirectly through an agent (usually a corporate credit union). Other notes issued by credit unions are generally payable to corporate credit unions or other financial institutions, or a Federal Reserve Bank.

15.09 Institutions and their subsidiaries sometimes finance expansion using traditional real estate mortgages.

Short-Term Debt

15.10 ***Repurchase Agreements.*** Repurchase agreements (repos) are discussed in Chapter 14, "Federal Funds and Repurchase Agreements."

15.11 ***Federal Funds Purchased.*** Federal funds purchased are discussed in Chapter 14.

15.12 ***Commercial Paper.*** Commercial paper is an unsecured promissory note that provides creditworthy institutions typically, finance companies or holding companies of banks and savings institutions with short-term funds. Commercial paper is generally short-term (at most 270 days, but usually much less) and negotiable.

15.13 Institutions that rely heavily on commercial paper generally sell and redeem it continuously. They may sell more commercial paper than needed on certain days simply to maintain a market for customers who wish to invest beyond the finance company's current needs. Sales of commercial paper may also increase when large amounts of commercial paper or long-term debt mature. Proceeds in excess of current needs are often invested by entering into repurchase agreements or by buying Eurodollar deposits, or commercial paper issued by others.

15.14 ***Lines of Credit.*** Institutions often obtain funds through lines of credit from banks and savings institutions.

15.15 Institutions may obtain lines of credit as a source of funds or to provide creditors with assurance that commercial paper and other shorter term debt will be repaid. Further, rating agencies generally will not rate a finance company's commercial paper if it is not supported by a line of credit.

15.16 Institutions may pay commitment fees, maintain compensating balances, or do both to have lines of credit available. Interest rates on borrowings under lines of credit are usually based on a spread over the lender's prime rate based on the lender's assessment of credit risk.

15.17 ***Borrowing From Federal Reserve Discount Windows and Federal Home Loan Bank System.*** Member depository institutions may borrow from their regional Federal Reserve Bank in the form of discounts (often called *rediscounts*) and advances, which are primarily used to cover shortages in the required reserve account and also in times of liquidity problems. Most institutions regard the discount window as a lender of last resort. A discounting transaction is technically a note to the Federal Reserve with recourse secured by a member institution's eligible loans. In an advancing transaction, a member institution executes a promissory note, which is collateralized generally by government securities to the Federal Reserve. Most discount-window transactions are in the form of advances. Interest charged in those transactions is referred to as *discount*. The rates are set biweekly by the individual reserve banks. Such loans usually have short maturities. Members of the FHLB System (FHLBs) can obtain advances of varying maturities from their district FHLBs. FHLB advances often are secured through pledges of loans or securities. Paragraph 15.63 discusses the performance of agreed-upon procedures relating to collateral for FHLB advances.

15.18 ***Treasury Tax and Loan Note Accounts.*** Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a bank or savings institution. Institutions record such deposits, which are non-interest-bearing, as treasury tax and loan accounts (TT&L accounts) and include such accounts with their deposits. However, on the day after receipt such funds must be remitted to the Federal Reserve Bank or converted into an open-ended, interest-bearing note, commonly referred to as a *treasury tax and loan note account*.

15.19 ***Bankers' Acceptances.*** A banker's acceptance, which often is used to finance shipments of goods to bank customers, is a short-term time draft that a bank (drawee) has agreed to pay at maturity by stamping "accepted" over the signature of an officer. When the bank accepts the draft, it guarantees its redemption at maturity, which makes the draft negotiable. In return for the guarantee, the party on whose behalf the bank accepts the draft (drawer) agrees to provide the bank with the necessary funds prior to maturity. The bank receives a fee for creating the acceptance. The drawer's outstanding debt to the bank is reported as an asset, and the bank's obligation is reported as a liability. Bankers' acceptances are similar to other short-term borrowed funds in that they can be effectively used for short-term liquidity needs by avoiding disbursing funds for short-term loans to bank customers. Readers may also refer to FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness* *of Others*, for guidance, since a banker's acceptance contains an obligation to stand ready, the initial fair value of which is likely to be the fee received.

15.20 In addition to FASB Interpretation No. 45, the FASB staff issued two FASB Staff Positions (FSP), FSP FIN 45-2, *Whether FASB Interpretation No. 45*, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, *provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value*, that was effective immediately, and FSP FIN 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners*. FSP FIN 45-3 should be applied for new minimum revenue guarantees issued or modified on or after the beginning of the first fiscal quarter following November 10, 2005.

15.21 ***Mortgage-Backed Bonds.*** Mortgage-backed bonds (MBBs) are any borrowings (other than those from an FHLB) collateralized in whole or in part by one or more real estate loans. MBBs typically have the following characteristics:

a. Fixed maturities or payments of principal and interest

b. The use as collateral of mortgage loans or mortgage-backed securities (MBSs) owned by the issuer

c. Stated or fixed interest rates with interest payable monthly or semiannually (There may also be call provisions.)

d. Principal payments made through periodic sinking-fund payments or at final maturity

e. Mortgage collateral in which the purchaser does not have an ownership interest

f. Collateral values usually ranging from 110 percent to 200 percent of the amount of the debt issue, so that the collateral exceeds the principal value during its entire outstanding life (overcollateralization)

15.22 The total mortgage collateral pool is generally overcollateralized to the extent necessary to provide assurance that the investor can sell the mortgage loans without loss in the secondary market should the MBB issuer default.

15.23 ***Preferred Stock and Other Obligations of Finance Subsidiaries.*** Finance subsidiaries, as defined in federal banking regulations, are a means by which institutions can issue preferred stock and other securities at rates lower than those the institutions would otherwise have to pay if they issued the securities directly. Thus, finance subsidiaries afford banking institutions the opportunity to obtain less costly funds.

15.24 In a structured financing (the simplest form of a finance subsidiary), the parent institution transfers certain assets to a special-purpose finance subsidiary to collateralize or otherwise support the securities issued by the finance subsidiary. In return for the assets, the subsidiary remits the net proceeds of the offering to the parent for use in operations. Where debt is issued at the subsidiary level, the trustee for the debt perfects a security interest in the transferred collateral. If preferred stock is issued, no security interest is perfected. However, because the finance subsidiary is chartered for the limited purpose of issuing the securities and can neither incur debt nor engage in any other business, the preferred stock is, in fact, insulated from other encumbrances and is, therefore, backed by the collateral in a manner approximating a security interest. The result is to provide greater protection for preferred stockholders than any of them would have had if the parent institution had been the issuer.

15.25 The economic value of this financing technique is made possible by a variety of factors. Because of the requirements established by the rating agencies, preferred stock offerings are significantly overcollateralized by a combination of mortgage securities, short-term money-market instruments, treasuries, and other securities. This degree of collateralization, combined with the protection afforded by the structure, enables the rating agencies to issue triple-A ratings. Additionally, because qualified corporate taxpayers holding preferred stock are eligible for a deduction of a specified percentage of dividends received, the dividends paid by the issuer can be low by market standards, making the transaction a low-cost "borrowing" for the parent.

15.26 ***CMOs.*** As introduced in paragraph 7.28, collateralized mortgage obligations (CMOs) are multiclass, pay-through bonds collateralized by MBSs or mortgage loans and are generally structured so that all, or substantially all, of the collections of principal and interest from the underlying collateral are paid to the holders of the bonds. Typically, the bonds are issued with two or more maturity classes; the actual maturity of each bond class varies depending upon the timing of the cash receipts from the underlying collateral. CMOs are usually issued by a minimally capitalized special-purpose corporation (issuer) established by one or more sponsors (that is, the original owners of the mortgages). The MBSs collateralizing the obligations are acquired by the special-purpose corporation and then pledged to an independent trustee until the issuer's obligation under the bond indenture has been fully satisfied. The investor agrees to look solely to those trusteed assets and the issuer's initial capital (collectively referred to as *segregated assets*) for repayment of the obligations. Therefore, the sponsor and its other affiliates no longer have any financial obligations for the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans.

15.27 For the sponsor of the CMO, cash is immediately generated; there is no waiting for the collection of the amounts when the respective mortgage payments come due. Credit enhancement of CMOs is generally achieved by using collateral that carries a third-party guarantee; otherwise, they are overcollateralized to mitigate the risk of default. The excess collateral reverts to the sponsor at the maturity of the CMOs. The sponsor of the CMO issuer may retain any residual (see Chapter 7, "Investments in Debt and Equity Securities"), or an unrelated third party may acquire the residual as an investment.

15.28 For both the issuer and investor, cash flows may not materialize as scheduled. For example, prepayments of the underlying mortgages at a greater-than-anticipated rate can reduce the yield to maturity expected by the investor.

15.29 ***Real Estate Mortgage Investment Conduits.*** Real estate mortgage investment conduits (REMICs) are vehicles for issuing multiclass mortgage-backed obligations that require compliance with a number of technical requirements of the Internal Revenue Code (IRC). REMICs refer to the taxable entity (rather than to the security structure like a CMO and other types of mortgage-backed borrowings). Failure to comply with the requirements could result in imposition of a corporate income tax on the gross income of the REMIC. REMIC certificates of ownership are qualifying real property loans and qualified assets under the IRC.

15.30 To qualify for REMIC status as defined by the IRC, all of the assets continuously held by the REMIC must consist of qualified mortgages and permitted investments. In general, the term, *qualified mortgages* refers to mortgages that are principally collateralized by an interest in real property and are transferred to the REMIC at the time of its formation or purchased by the REMIC within three months of its formation. Qualified mortgage also refers to a regular interest in another REMIC. The term *permitted investments* includes cash-flow investments, qualified reserve assets, and foreclosed property.

15.31 All of the interests in the REMIC must consist of either regular interests or residual interests. A regular interest is an interest that unconditionally entitles the holder to receive specified principal and interest payments under terms that are fixed at the time of the REMIC's formation. A residual interest is any interest in a REMIC that is not a regular interest. Only one class of residual interest may exist with respect to a REMIC. In other words, the rights of all of the holders of interests that do not qualify as regular interests must be exactly the same.

Regulatory Matters

15.32 Institutions regulated by the Office of Thrift Supervision (OTS) must notify the OTS before borrowing money, unless the institution meets regulatory capital requirements and any applicable minimum capital directive. Regulations may also prohibit growth above a certain level without prior regulatory approval. Further, savings institutions must obtain written approval (prior to issuance) for subordinated debt to qualify as regulatory capital.

15.33 The Federal Reserve Act limits the availability of borrowings through the Federal Reserve discount window for certain borrowings.

Accounting and Financial Reporting

15.34 Statement of Position (SOP) 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*,[†] paragraph 14*(f)* states that significant categories of borrowings should be presented as separate line items in the liability section of the balance sheet, or as a single-line item with appropriate note disclosure of components. Institutions may, alternatively, present debt based on the debt's priority (that is, senior or subordinated) if they also provide separate disclosure of significant categories of borrowings. Paragraph 15(a) of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,[2] explains how a debtor should report (in the statement of financial position) collateral provided in any borrowing.

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† In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. This Statement revised language contained in paragraph 10 of FASB Statement No. 140. As a result, the language in SOP 01-6, paragraph 8(h), was revised to remove reference to paragraph 10(b) of FASB Statement No. 140. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

2 The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. Readers should monitor developments on this proposal. In November of 2005 the FASB staff issued FASB Staff Position (FSP) FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*." This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

15.35 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

15.36 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

15.37 SOP 01-6, paragraph 14(*f*), states that for debt, the notes to the financial statements should describe the principal terms of the respective agreements including, but not limited to the title or nature of the agreement, or both; the interest rate (and whether it is fixed or floating); the payment terms and maturity date(s); collateral; conversion or redemption features; whether it is senior or subordinated; and restrictive covenants (such as dividend restrictions), if any.

15.38 SOP 01-6, paragraph 14(*g*), states that accounting and reporting requirements for long-term obligations are the same for financial institutions as for other entities. If the financial institution has an unclassified balance sheet, there is no need to separate balances into current and long-term portions.[3] Costs related to the issuance of debentures or other debt should be deferred and amortized to interest expense using the effective interest method over the life of the issue.

15.39 FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*,[4] established

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[3] FASB Statement No. 47, *Disclosure of Long-Term Obligations*, requires disclosure of future payments on long-term borrowings.

[4] The FASB has issued the following FSPs associated with the issuance of FASB Statement No. 150:

1. FSP FAS 150-2, *Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares, under FASB Statement No. 150*, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This FSP was effective immediately for freestanding financial instruments issued by entities to which the requirements of FASB Statement No. 150 have already been applied. The guidance should be applied for other entities as part of the adoption of FASB Statement No. 150. If this guidance results in changes to previously reported information, the cumulative effect should be reported according to the provisions of FASB Statement No. 150.

(continued)

standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This Statement requires an issuer to classify the following instruments as liabilities (or assets in some circumstances):

- A financial instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur
- A financial instrument, other than an outstanding share, that, at inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (for example, a forward purchase contract or written put option on the issuer's equity shares that is to be physically settled or net cash settled)
- A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following:

    a. A fixed monetary amount known at inception, for example, a payable settleable with a variable number of the issuer's equity shares

    b. Variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares

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(footnote continued)

2. FSP FAS 150-3 deferred the effective date of FASB Statement No. 150 for mandatorily redeemable financial instruments issued by nonpublic entities that are *not* Securities and Exchange Commission (SEC) registrants, as follows:

    a. For instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index, the classification, measurement, and disclosure provisions of FASB Statement No. 150 was effective for fiscal periods beginning after December 15, 2004

    b. For all other financial instruments that are mandatorily redeemable, the classification, measurement, and disclosure provisions of FASB Statement No. 150 are deferred indefinitely pending further Board action. During that indefinite deferral, the Board plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those instruments in conjunction with the Board's ongoing project on liabilities and equity

3. FSP FAS 150-5, *Issuer's Accounting under Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*. The guidance in this FSP should be applied to the first reporting period beginning after June 30, 2005. If the guidance in this FSP results in changes to previously reported information, the cumulative effect shall be reported according to the transition provisions of FASB Statement No. 150 in the first reporting period beginning after June 30, 2005.

c. Variations inversely related to changes in the fair value of the issuer's equity shares, for example, a written put option that could be net share settled

15.40 ***Redeemable Preferred Stock.*** Paragraph 9 of FASB Statement No. 150 states, "A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity."[5] Therefore, FASB Statement No. 150 requires that redeemable preferred stock be classified as a liability in the consolidated financial statements but only if it is mandatorily redeemable as defined by that Statement. Paragraph 18 of FASB Statement No. 150 states, "Items within the scope of this Statement shall be presented as liabilities... Those items shall not be presented between the liabilities section and equity section of the statement of financial position." However, FASB Statement No. 150 does not address redeemable preferred stock that is conditionally redeemable (for example, stock that is puttable by the holder at a specified date). Mezzanine presentation would continue to apply for conditionally redeemable stock that is not in the scope of FASB Statement 150. (Also see paragraph 17.13 for a discussion of these types of preferred stock and regulatory capital).

15.41 ***Bankers' Acceptances.*** Paragraphs 107 through 111 of FASB Statement No. 140[6] discuss banker's acceptances and risk participations in them. Paragraph 110 of FASB Statement No. 140 says an accepting bank that obtains a risk participation should not derecognize the liability for the banker's acceptance because the accepting bank is still primarily liable to the holder of the banker's acceptance even though it benefits from a guarantee of reimbursement by a participating bank. Paragraph 110 requires that the accepting bank should not derecognize the receivable from the customer because it controls the benefits inherent in that receivable and it is still entitled to receive payment from the customer. Paragraph 110 says the accepting bank should, however, record the guarantee purchased, and the participating bank should record a liability for the guarantee issued. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*,[7] addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. The Interpretation also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee.

15.42 ***Mortgage-Backed Bonds.*** SOP 01-6, paragraph 14(*i*), states that "transfers of mortgages accounted for under FASB Statement No. 140 as secured borrowings of the issuing institution should be classified as debt on the institution's balance sheet. Such MBBs should be classified separately from advances, other notes payable, and subordinated debt." Consistent with Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables* (paragraphs 15 and 16), as amended, and FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (paragraphs 235 to 239), any discounts or premiums associated with the issuance of MBBs should be recorded in a contra liability (debit) or liability (credit) account. Bond issue costs or expenses (legal, accounting, printing, and other expenses) should be

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[5] See footnote 4.

[6] See footnote 2.

[7] See footnote 2.

deferred and amortized to operations using the constant effective yield method over the life of the bonds.

15.43 In accordance with FASB Statement No. 47, *Disclosure of Long-Term Obligations*, institutions should disclose maturity and sinking-fund requirements for each of the five years following the last balance-sheet date. Further, if debt was considered in-substance defeased in an extinguishment occurring before January 1, 1997, a general description of the transaction and the amount of the debt that is considered extinguished at the end of the period should be disclosed as long as the debt remains outstanding.

15.44 ***Extinguishments of Liabilities.***[8] FASB Statement No. 140 provides accounting and reporting standards for extinguishments of liabilities. Paragraph 16 of FASB Statement No. 140 says a debtor should derecognize a liability if and only if it has been extinguished. Paragraph 16 says a liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. Paragraph 114 of FASB Statement No. 140 provides related guidance.

Readers may refer to EITF Issue No. 96-19, for further guidance on debt extinguishments.

15.45 ***Foreign Currency Debt.*** FASB Emerging Issues Task Force (EITF) Issue No. 86-25, *Offsetting Foreign Currency Swaps*, addresses how the effect of a change in exchange rates on a foreign currency swap contract should be displayed in the balance sheet. Readers may also refer to FASB Statement No. 133,[9] as amended, for further guidance.

15.46 ***Dual Currency Bonds.*** FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, paragraph 15, addresses accounting for the effect of a change in foreign currency rates on dual currency bonds.

15.47 ***REMICs.*** As discussed earlier, REMIC is simply a label that covers various forms of underlying securities. These securities may resemble either CMOs or pass-through certificates that represent a transfer of the underlying receivables. Institutions may enter into REMIC transactions to raise immediate cash from mortgage agreements. As discussed beginning in paragraph 7.79, FASB Statement No. 140 provides accounting and reporting standards for transfers of financial assets, including transfers associated with REMICs and CMOs.

15.48 All transaction costs associated with an offering accounted for as a sale should be expensed when the associated collateral is eliminated from the financial statements and the resultant gain or loss is recognized.

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[8] See footnote 2.

[9] See footnote 2 in paragraph 15.33 for amendments to FASB Statement No. 133.

Lease Financing

15.49 Accounting for leases by lessees and lessors is established by FASB Statement No. 13, *Accounting for Leases*,[10] as amended. Other interpretive pronouncements address additional circumstances.

Lending of Customers' Securities

15.50 Paragraphs 91 through 95 of FASB Statement No. 140[11] discuss application of the Statement to securities lending transactions. Banks and savings institutions sometimes lend customers' securities. Any contingencies related to the lending of securities should be accounted for in conformity with FASB Statement No. 5, *Accounting for Contingencies*.

Fair-Value Disclosures

15.51 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended, requires disclosures of fair values of all financial instruments for which it is practicable to estimate fair value.[12] Paragraph 28 of FASB Statement No. 107 says that "a fair value for financial liabilities for which quoted market prices are not available can generally be estimated using the same techniques used for estimating the value of financial assets" and provides further guidance.[‡]

Auditing

Objectives

15.52 The primary audit objectives in this area are to obtain reasonable assurance that:

a. Short- and long-term borrowings recorded as of the date of the financial statements include all such liabilities of the institution and that they have been properly valued, classified, described and disclosed, and reflect all transactions for the period.

b. Financing subsidiaries are consolidated with the parent institution as required by FASB Statement No. 94, *Consolidation of All*

[10] The staff of the FASB has issued FASB Staff Position (FSP) 13-1, *Accounting for Rental Costs Incurred during a Construction Period*. The guidance in this FSP shall be applied to the first reporting period beginning after December 15, 2005. Early adoption is permitted for financial statements or interim financial statements that have not been issued.

[11] See footnote 3.

[12] FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment of FASB Statement No. 107*, as amended, amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

[‡] FASB Statement No. 159, paragraph 17, requires entities to disclose the use of the fair value option described by the statement, excluding securities classified as trading under FASB Statement No. 115. FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of Statement No. 157. The FASB issued Statement No. 157, *Fair Value Measurements*. The effective date of FASB Statement No. 157 is November 15, 2007, with early application encouraged.

Majority-Owned Subsidiaries, and to address consolidation by business entities with certain characteristics, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003) (FIN No. 46(R)).[13,14,15]

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[13] Application of FIN No. 46 (R) is required for public entities that have interests in entities commonly referred to as variable interest entities. Application by small business issuers to *variable interest entities* other than *special-purpose entities* and by nonpublic entities to all types of *variable interest entities* was required at various dates in 2004 and 2005.

[14] The FASB issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs, FIN 46(R), FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 were replaced by FIN 46-2, FIN 46-5, and FIN 46-8, respectively, with the effective dates and transition provisions applied accordingly.

5. FSP FIN 46(R)-5, "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*" (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) For entities to which Interpretation 46(R) has been applied, the guidance in this FSP was applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) was permitted but not required. Early application was permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).
6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, Consolidation of Variable Interest Entities." Effective for all arrangements to which FIN 46 had been applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change had been reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).
7. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)" An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

[15] For additional assistance, refer to the AICPA's Technical Practice Aid (TPA) 1400.29, "Consolidated Versus Combined Financial Statements under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*" (www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf).

c. Interest expense and the related balance-sheet accounts (accrued interest payable, unamortized premiums or discounts, and issuance costs) are properly measured and recorded, and amortization has been properly computed.

d. Transactions representing an extinguishment of debt through an in-substance defeasance before January 1, 1997, are properly evaluated and reported, and any related gains or losses on the transactions are properly calculated and reported.

e. Collateral for borrowings is properly identified and disclosed.

f. Borrowings have been authorized in accordance with management's written policies and are obligations of the institution.

g. The effects on reported amounts and disclosures of any noncompliance with debt covenants are properly identified, described, and disclosed.

Planning

15.53 In planning accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing inherent the risks of material misstatements,[16] which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to financial statement the relevant assertions about related to other borrowings. Such factors might include regulatory considerations, the existence of restrictive covenants, and the existence and adequacy of collateral, if applicable. The independent accountant might also review board of directors' reports, the current-year's interim financial statements, and other documents that may include information about whether any significant new debt has been incurred or issued and whether any significant debt has been repaid or refinanced. The independent accountant should also inquire as to obtain audit evidence about the nature of the entity, for example, the existence of financing subsidiaries.

Internal Control Over Financial Reporting and Possible Tests of Controls

15.54 AU section 314 establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material

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[16] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

misstatement at both the overall financial statement level and at the assertion level.

15.55 ***Audits performed in accordance with PCAOB standards.*** [||] AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with generally accepted auditing standards (GAAS). It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph .25 of AU section 319 requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to plan the audit. A sufficient understanding is obtained by performing procedures to understand the design of policies and procedures relevant to an audit of financial statements and determining whether they have been placed in operation. The auditor is also required to assess control risk for the relevant assertions embodied in the account balances, transaction class, and disclosure components of the financial statements.

15.56 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Controls relating to the financial reporting of debt include the following:

- Debt transactions are reviewed and approved by the board of directors or its designated committee and documented in the minutes.
- Debt agreements are reviewed by the appropriate accounting and legal personnel to ensure that borrowings meet GAAP criteria for classification as a liability.
- Adjustments to liability accounts are reviewed and approved by a responsible official.
- The institution is named as issuer or borrower in the respective credit or financing agreements.
- All off-balance-sheet obligations (such as operating leases and guarantees) have been identified, described, and disclosed.
- The subsidiary ledgers for long- and short-term borrowings and collateral are periodically reconciled with the general ledger.
- Reports or statements from outside trustees or transfer agents are periodically reconciled to the institution's records.
- Through periodic confirmation with the trustee or transfer agent, the institution ascertains that collateral on borrowings remains sufficient.
- Borrowings (such as CMOs and REMICs) are reviewed to ensure that they meet the GAAP criteria for treatment as financing transactions.

[||] See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 2 and related conforming amendments to the PCAOB Standards.

- Periodic tests of covenant compliance are performed and reviewed by responsible personnel.

15.57 Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 for a discussion on the extent of test of controls (AICPA, *Professional Standards*, vol. 1). Also, refer to Appendix B in Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing.

15.58 AU section 324,[17] *Service Organizations* (AICPA, *Professional Standards*, vol. 1), paragraphs .06 through .21, provide guidance on the user auditor's consideration of the effect of a service organization on internal control of the user organization and availability of audit evidence. That guidance should be considered when planning and performing the audit of the financial statements of an institution that obtains services from another organization that are part of its information system (for example, processing CMO or REMIC cash flows by a trustee). When performing an integrated audit, refer to Auditing Standard No. 2, paragraph 218 regarding the use of service organizations.

Substantive Tests

15.59 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to debt.

15.60 ***Review of Documentation.*** The independent accountant should consider reviewing documentation such as legal agreements and notes supporting long-term debt and agree pertinent information to subsidiary ledgers. The independent accountant should consider reviewing the following information:

a. Type of debt

b. Interest rate and dates interest is payable

c. Maturity of the debt

d. Underlying collateral of the debt, if any

e. Subordination of the debt

f. Evidence of regulatory approval, if required

g. Presence of restrictive covenants

h. Unusual features

i. Embedded derivatives

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[17] The AICPA Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*, includes illustrative control objectives as well as Interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

15.61 ***Confirmation.*** The independent accountant should consider confirming pertinent information with the trustee or transfer agent, including all terms, unpaid balance, accrued interest payable, principal and interest payments made during the year, collateral description, annual trust accounts activity, and the occurrence of any violations of the terms of the agreement. If collateral is not under the control of the institution and is held by a trustee or transfer agent, the independent accountant should consider confirming its existence, completeness, and valuation with the trustee or transfer agent. If collateral is deemed deficient with respect to the terms of the debt agreement or is not under the control of the institution, the independent accountant should consider the need for disclosure.

15.62 ***Tests of Valuation.*** The independent accountant should consider testing borrowings that were issued at a premium or discount to determine whether amortization has been properly computed and recorded. The independent accountant should also evaluate the propriety of amortization of costs incurred in connection with a debt issuance. The independent accountant should consider assessing the sufficiency of the value of assets collateralizing any borrowings by confirmation.

15.63 ***Analytical Procedures.*** Analytical review procedures can provide substantive evidence about the completeness of debt-related financial statement amounts and disclosures; however, such procedures in tests of debt expense are often less precise than substantive tests such as recalculations. Because institutions generally issue a wide variety of debt with rates that vary with each issuance, it is normally difficult to develop expectations to be used in analyzing yields on debt. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive tests. Further guidance is provided in AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), and AU section 326, *Audit Evidence*, (AICPA, *Professional Standards*, vol. 1). The independent accountant should be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends should be considered to determine if the institution's trend appears reasonable. Following are some of the analytical review procedures that should be considered:

- Compare interest expense by major category of debt as a percentage of the average amount of the respective debt outstanding during the year with stated rates on the debt instruments (yield test).
- Evaluate the reasonableness of balance-sheet accruals and other related balance-sheet accounts (accrued interest payable, deferred issuance costs, and premiums and discounts) by comparison to prior-year balances.

15.64 When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.[||]

15.65 For significant risks of material misstatement in an integrated audit, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

15.66 ***Other Procedures.*** Other audit procedures the independent accountant may consider related to debt and the extinguishment of debt are as follows:

- Review debt covenants and test whether the institution has complied with such covenants. Determine whether disclosures are appropriate.
- Read minutes of meetings of the board of directors to determine whether financing transactions have been authorized in accordance with the institution's written policies.
- Compare recorded interest expense and accrued interest payable to recorded debt for completeness of debt liabilities.
- Obtain a detailed supporting schedule of prior-year and current-year account balances. Agree the prior-year balance to prior-year working papers and the current-year balance to the general ledger. Review activity for reasonableness.
- For CMOs and REMICs, obtain and review compliance and verification letters prepared by the trustee's independent accountants. (Such letters are prepared on an annual basis and provide for the verification of the principal balance of the collateral and bonds, the cash flows associated with the issue, and compliance with the respective terms of the underlying agreements.)
- Examine canceled notes for borrowings that have been paid in full.
- Read lease agreements, identifying those that should be capitalized, and determine whether they were recorded using effective rates of interest.

15.67 If applicable, the independent accountant may be engaged to perform agreed-upon procedures relating to collateral for FHLB advances by reference to the security agreement signed by the institution's management that indicates compliance. The procedures depend upon the nature of the agreement (blanket lien, specific lien without delivery, or specific lien with delivery of the collateral). The respective district FHLB should provide guidance on procedures to be performed. However, the independent accountant should consider whether and how to perform all that is requested by the FHLB district bank in light of the professional standards.

15.68 Some debt agreements may require companies to have their independent auditors issue compliance reports on various restrictive covenants involving matters such as restrictions on assets, payments of interest, and dividend payments. Such reports, which normally are in the form of negative assurance, are discussed in AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1).

[||] See footnote || in paragraph 15.55.

15.69 ***Finance Company Credit Questionnaires.*** Finance companies provide creditors with financial and operating information through standard credit questionnaires developed jointly by industry and Robert Morris Associates (an association of lending officers). Some finance companies include credit questionnaires as information in addition to the finance company's basic financial statements. The independent accountant's responsibility depends on the services requested by the finance company.

15.70 Paragraph .04 of AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor Submitted Documents* (AICPA, *Professional Standards*, vol. 1), says an independent accountant who submits a document containing audited financial statements to the client or to others has a responsibility to report on all the information (such as a credit questionnaire) included in the document. However, AU section 551 explains that, when the independent accountant's report is included in a client-prepared document and the auditor is not engaged to report on information accompanying the basic financial statements, the independent accountant should follow AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

Chapter 16

Income Taxes*, [1]

Introduction

16.01 Depository institutions generally are subject to the same tax rules that apply to other corporations, including those that are members of a consolidated group. Generally, credit unions are exempt from federal income taxes. Banks and savings institutions are permitted to elect subchapter S status under Internal Revenue Code (IRC) Section 1362, provided certain requirements are met. Among these requirements are a 100-shareholder limitation (including family attribution), one class of stock restriction and prohibition on the use of the reserve method of accounting for bad debts for tax. If elected, S corporation status essentially converts the financial institution to a pass-through entity for tax purposes so that most of the corporate level tax on income is avoided.

16.02 The IRC contains many provisions specific to taxable depository institutions. Finance and mortgage companies generally are subject to the same tax rules that apply to other corporations. The purpose of this chapter is to highlight certain federal tax matters and related accounting matters specific to the industry and to provide related auditing guidance.[2]

Banks and Savings Institutions

16.03 ***Definition of a Bank for Tax Purposes.*** IRC Section 581 defines a bank for tax purposes and provides special rules governing bank taxation.

16.04 ***Definition of a Savings Institution for Tax Purposes.*** Savings institutions are considered to be mutual savings banks (IRC Section 591), domestic building and loan associations (IRC Section 7701(a)(19)), or cooperative banks (IRC Section 7701(a)(32)). The failure of an institution to qualify as a savings institution may affect the financial accounting standards that apply.

16.05 ***Securities Gains and Losses.*** IRC Section 582 provides banks special treatment for certain asset dispositions. Gains and losses on bonds, debentures, notes, certificates, and other evidences of indebtedness held by banks generally are treated under IRC Section 582 as ordinary (rather than capital) gains and losses. Equity securities and other investments generally are not afforded IRC Section 582 ordinary treatment. IRC Section 582 generally is not

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] For audits of issuers, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the Securities and Exchange Commission (collectively referred to as "issuers"), Section 202 of the Act and the SEC Rule, *Strengthening the Commission's Requirements Regarding Auditor Independence*, require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor. This includes tax services.

[2] This chapter is not intended to provide comprehensive discussion of all possible tax matters an accountant might encounter in the preparation or audit of the financial statements of a financial institution. Further, state tax matters are beyond the scope of the introductory section of this chapter. Consulting this chapter cannot take the place of a careful reading of the related laws, regulations, rulings, and related documents, where appropriate.

applicable to nonbank subsidiaries, including, for example, passive investment companies established for state planning purposes.

16.06 ***Tax Bad-Debt Deductions.*** IRC Section 585 provides that a bank or savings institution with $500 million or less in assets is allowed a tax bad-debt deduction for reasonable additions to the bad-debt reserve. This asset test generally is based upon the average adjusted tax basis of all assets. If the institution is a member of a controlled group (as defined), all assets of the group are taken into account. The annual addition to the reserve generally cannot exceed the greater of the amount computed using actual experience percentages or the base year fill-up method (as defined).

16.07 A bank or savings institution with assets exceeding $500 million generally is allowed to claim a tax bad-debt deduction only under the general rule of IRC Section 166, which generally permits taxpayers to deduct any debt that becomes worthless, in whole or in part, during the taxable year (the *specific chargeoff* method[3]).

16.08 A bank or savings institution also may be required to recapture a portion of its bad-debt reserves if it makes distributions to shareholders that exceed earnings and profits accumulated after 1951. Additionally, if a savings institution makes a distribution in redemption of stock or in partial or complete liquidation, notwithstanding the existence of earnings and profits, a portion of the reserve may have to be recaptured. Exceptions to this rule exist for certain tax-free reorganizations and certain distributions to the Federal Deposit Insurance Corporation (FDIC) in redemption of an interest if such interest was originally received in exchange for assistance provided (see IRC Section 597(c)).

16.09 ***Net Operating Losses.*** For taxable years beginning after August 5, 1997, net operating losses (NOLs) of banks and savings institutions generally are carried back two years and then forward twenty years under the provisions of IRC Section 172. For taxable years prior to 1994, banks and savings institutions also had various special provisions in the IRC that determined the appropriate carryback and carryforward periods.

Other

16.10 ***Alternative Minimum Tax.*** Beginning in 1987, corporations generally must compute their federal tax liability under both the regular tax and alternative minimum tax (AMT) systems and pay the higher amount. The AMT system is a separate but parallel tax system in which regular taxable income is increased or decreased by certain AMT adjustments and preference items to arrive at AMT income. A rate of tax generally lower than the regular tax rate is applied to AMT income. The AMT adjustments and preference items most common for banks include tax-exempt interest income on private activity bonds issued after August 7, 1986 (reduced by any related interest expense disallowance), and accelerated depreciation and cost recovery. An adjustment is also required for the adjusted current earnings (ACE) amount (defined), which frequently includes additional modifications for all tax-exempt interest income, the dividends received deduction, and the increase in the cash surrender value of life insurance over the premiums paid. Further, only 90 percent of AMT income may be offset by a net operating loss (NOL). Any excess of tax computed under the AMT system over the regular system generally is eligible to reduce future regular tax (a minimum tax credit).

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[3] Finance companies and mortgage companies also use the specific charge-off method.

16.11 ***Mark to Market.*** IRC Section 475 generally requires any company that is a dealer in securities to mark its securities to market. A dealer is broadly defined as any taxpayer that regularly purchases securities from, or sells securities to, customers in the ordinary course of business. The definition of securities differs from and is generally more expansive than the definition of securities in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.[4,†] For purposes of IRC Section 475 nonsecuritized loans are, in some circumstances, considered securities. Further, institutions generally may not exempt any security held for investment if it is identified as such at the date of acquisition. A window (sometimes as much as 30 days) has generally been allowed for identification of certain loans.

16.12 ***Interest Expense Relating to Tax-Exempt Income.*** IRC Section 291 generally provides that 20 percent of the allocable interest expense attributable to tax-exempt obligations acquired by a financial institution after 1982 and before August 8, 1986, is not deductible. For tax-exempt obligations acquired after August 7, 1986, IRC Section 265 generally requires that all of the interest expense attributable to the obligation be nondeductible. An exception exists for certain "qualified small issuer" obligations (as defined), which are subject to IRC Section 291.

Credit Union

16.13 Federal credit unions are exempt from federal and state income tax. State chartered credit unions may be subject to state income tax. Credit Union Service Organizations (CUSOs), which are subsidiaries of federal or state credit unions, may be subject to unrelated business income tax (UBIT) for federal income tax purposes.

Regulatory Matters

16.14 The Federal Financial Institutions Examination Council (FFIEC) requires, for regulatory reporting purposes, that income taxes be accounted for in conformity with generally accepted accounting principles (GAAP). However, income taxes receive special treatment in regulatory capital calculations as the federal banking regulatory agencies limit the amount of deferred tax assets that may be included in regulatory capital.

16.15 In 1998, the federal banking agencies adopted an Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure. The policy statement, which does not materially change any of the guidance previously issued by the agencies, generally, requires that intercorporate tax settlements between an institution and its parent company be no less favorable to the institution than if it were a separate taxpayer. Taxes should not be paid to the parent before the payment would have been due to the taxing authority and if the subsidiary incurs a tax loss, it should receive a refund from the parent.

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[4] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in this FSP should be applied to reporting period beginning after December 15, 2005.

[†] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The effective date is November 15, 2007. Entities may opt for early adoption of Statement 159, subject to conditions outlined in the Statement.

Adjustments for statutory tax considerations which arise in a consolidated return are permitted if they are made on an equitable basis, consistently applied to all affiliates. These rules generally require that deferred taxes of the institution may not be paid or transferred to, or forgiven by, its holding company. The agencies recommend that members of a consolidated group have a written comprehensive tax agreement to address intercorporate tax policies and procedures.

16.16 Internal Revenue Service (IRS) regulations permit an institution to obtain evidence, from its primary regulator, stating that the institution maintains and applies loan review and loss classification standards consistent with the agency's regulations regarding loan chargeoffs. Each of the federal banking regulatory agencies has implementing guidance on this express determination letter process.

Accounting and Financial Reporting

16.17 FASB Statement No. 109, as amended, *Accounting for Income Taxes*,[5] established the accounting for the effects of income taxes that result from an institution's activities during the current and preceding years. It requires an asset-and-liability approach for financial accounting and reporting for income taxes and, therefore, has a balance-sheet orientation. The objectives of accounting for income taxes in conformity with FASB Statement No. 109 are to recognize (*a*) the amount of income taxes payable or refundable for the current year and (*b*) deferred tax liabilities and assets for future tax consequences of events that have been recognized in an institution's financial statements or tax returns.

16.18 FASB Statement No. 109, as amended, applies the following basic principles in accounting for income taxes at the date of the financial statements:

- A current income tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The determination of the current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of current and deferred tax assets is reduced through a valuation allowance, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

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[5] In December of 2004, the FASB directed its staff to issue two FASB Staff Positions (FSP): FSP Interpretation No. FAS 109-1, *Application of FASB Statement No. 109*, Accounting for Income Taxes, *for the Tax Deduction Provided to U.S. Based Manufacturers by the American Jobs Creation Act of 2004*, and FSP Interpretation No. FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* to provide accounting and disclosures guidance on deductions arising from the American Jobs Creation Act of 2004. Both FSPs were effective on issuance.

Deferred-Tax Assets and Liabilities

16.19 In general, FASB Statement No. 109 requires that a deferred tax liability be recognized for all taxable temporary differences (for example, book and tax bases differences that will result in future taxable amounts). Deferred tax assets are to be recognized for deductible temporary differences (that is, book and tax bases differences of assets and liabilities that will result in future deductible amounts) and for tax NOL and credit carryovers. The determination of deferred taxes (paragraph 17(e) of FASB Statement No. 109) includes reduction of deferred tax assets by a valuation allowance (as defined) if:

> based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.

16.20 Paragraph 26 of FASB Statement No. 109 generally requires that a change in the amount of the valuation allowance be recognized in income in the period of the change.

16.21 FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. The Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted.[‡]

16.22 FASB Interpretation No. 48 serves to provide specific guidance, not contained in FASB Statement No. 109, on how to address uncertainty in accounting for income tax assets and liabilities.

Temporary Differences

16.23 A *temporary difference* is a difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the assets or liability is recovered or settled, respectively (see paragraph 289 of FASB Statement No. 109). Examples of temporary differences common to financial institutions follow:

- *Bad-debt reserves* for institutions that deduct bad-debt reserves under IRC Section 585 (which excludes the base year amount discussed at paragraph 16.26) and bad-debt reserves for financial statement purposes in excess of the bad-debt reserve for tax purposes. (For larger institutions that are covered under IRC Section 166, there is no bad-debt reserve for tax purposes and, therefore, the entire allowance for credit losses in the financial statements is a temporary difference.)

[‡] The FASB recently issued FASB FSP FIN 48-a, which amends FASB FIN 48, *Accounting for Uncertainty in Income Taxes*. The purpose of the amendment to FIN 48 is to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. The guidance in the FSP shall be applied upon the initial adoption of Interpretation 48.

- *Unrealized gains or losses on securities* under FASB Statement No. 115 may differ from amounts recognized under IRC Section 475.
- *Other real estate owned and other assets* may reflect post-acquisition impairment write-downs in the financial statements; those write-downs are generally not recognized for tax purposes until the asset is sold or disposed of for a bank. (For a savings institution, assets acquired before 1996 will generally be treated as a loan until sold.)
- *Accrued deferred compensation* is not deductible for tax purposes until paid.
- *Accrued loss contingencies* are generally not deductible for tax purposes until paid.
- *Depreciation of property, plant, and equipment* and the amortization of intangible assets may be different for financial statement and tax purposes.
- *Accrual of retirement liabilities* is often made in the financial statements in different periods from those in which the expense is recognized for tax purposes.
- *Other basis differences* in assets and liabilities are caused by the following:
  - — *Gains and losses on sales* of loans, foreclosed assets, or property, plant, and equipment recognized in financial reporting periods different from tax periods
  - — *Amortization of imputed interest income* from transactions involving loans recognized in different periods for financial reporting and tax purposes
  - — *Accretion of discount on securities* recorded currently for financial reporting purposes, but subject to tax at maturity or sale, or accreted differently for tax purposes
  - — *Carryover tax basis of assets and liabilities* in a transaction that is accounted for under the purchase method of accounting in accordance with FASB Statement No. 141, *Business Combinations*
  - — *Commitment fees* included in taxable income when collected but deferred to a period when earned for financial reporting purposes
  - — *Loan fee income* recognized on a cash basis for tax purposes while recognized as a yield adjustment for financial reporting purposes
  - — *Federal Home Loan Bank (FHLB) stock dividends* recognized as current financial reporting income but deferred for tax purposes
  - — The timing of the recognition of *income or loss for hedges and swaps* that differ for financial reporting and tax purposes

Financial Statement Presentation and Disclosure

16.24 Paragraphs 41 through 49 of FASB Statement No. 109 establish requirements for financial statement presentation and disclosure of income taxes.

16.25 Paragraph 44 of FASB Statement No. 109 requires that, whenever a deferred tax liability is not recognized because of certain exceptions addressed by Accounting Principles Board (APB) Opinion No. 23, *Accounting for Income Taxes—Special Areas* (as amended by FASB Statement No. 109), the following information should be disclosed:

- A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
- The cumulative amount of each type of temporary difference
- The amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement such determination is not practicable
- The amount of the deferred tax liability for other temporary differences that is not recognized in accordance with the provisions of paragraphs 31 and 32 of FASB Statement No. 109

16.26 Bad-debt reserves for tax purposes of U.S. savings institutions (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount), are included in paragraph 31 of FASB Statement No. 109 as one example of temporary differences of banks or savings institutions for which a deferred tax liability is not recognized when the "indefinite reversal criteria" of APB Opinion No. 23 are met.

16.27 Paragraph 46 of FASB Statement No. 109 requires that institutions disclose the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items addressed in paragraphs 35 through 39 of the Statement. For example, the amount of income tax expense or benefit allocated to certain items whose tax effects are charged or credited directly to other comprehensive income (such as translation adjustments under FASB Statement No. 52, *Foreign Currency Translation*, or changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115) should be separately allocated and disclosed.

Auditing

Objectives

16.28 The objectives of auditing income taxes are to obtain reasonable assurance that:

a. The provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with GAAP.

b. Deferred income tax liabilities and assets accurately reflect the future tax consequences of events that have been recognized in the institution's financial statements or tax returns (temporary differences and carryovers).

Planning

16.29 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements,[6] which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to income taxes. The independent accountant should be aware that the tax laws specific to financial institutions, as well as to general corporate taxation, can change from year to year.

Internal Control Over Financial Reporting and Possible Tests of Controls

16.30 AU section 314, establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314 requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

16.31 ***Audits performed in accordance with PCAOB Standards.*** AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), as amended, provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements performed in accordance with GAAS. It describes the components of internal control and explains how an independent accountant should consider internal control in planning and performing an audit. Paragraph .25 of AU section 319 requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to plan the audit. A sufficient understanding is obtained by performing procedures to understand the design of policies and procedures relevant to an audit of financial statements and determining whether they have been placed in operation. The auditor is also required to assess control risk for the relevant assertions embodied in the

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[6] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

account balances, transaction class, and disclosure components of the financial statements.

16.32 In addition to the above, when performing an integrated audit of financial statements and internal control over financial reporting, in accordance with PCAOB Standards, refer to Auditing Standard No. 2, paragraph 104 for a discussion on the extent of test of controls.[7] For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

16.33 The independent accountant should obtain an understanding of relevant internal controls. It may be more efficient and effective to assess control risk at the maximum for income taxes and take a primarily substantive approach. Chapter 5 discusses related considerations.

Substantive Tests

16.34 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to income taxes.

16.35 Substantive audit procedures may include the following:

- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current-year acquisitions of other companies and their preacquisition tax liabilities and exposures.
- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree amounts to general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.
- Test the rollforward of tax balance-sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior-year tax accrual to the actual filed tax return and determine the propriety of adjustments made in this regard and consider the impact on the current year's tax accrual.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income or franchise taxes.
- Review classification and description of accounts to identify possible tax reporting differences such as reserves for anticipated losses or expenses.
- Review schedule of NOL and other tax credit carryforwards and their utilization.

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[7] Paragraphs B18–B29 in Appendix B of Auditing Standard No. 2 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") provides further guidance.

- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets. The auditor should recognize that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be evaluated based upon the likelihood of realization, taking into account the timing of the bad-debt deduction, and the special NOL carryovers and carryback tax rules, if applicable.
- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB Statement No. 109.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB Statement No. 5, *Accounting for Contingencies*. Review recent Revenue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years for impact on tax contingencies. (The auditor should also review Coordinated Issue Papers issued by the IRS for banks and savings institutions to determine their impact on tax contingencies.)
- Evaluate the adequacy of the financial statement disclosures.
- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory accounting rules for banks and savings institutions related to intercompany tax allocation and settlement.

Chapter 17

Equity and Disclosures Regarding Capital Matters*

Introduction

17.01 Chapters 1 and 2 discuss the regulatory capital requirements for banks and savings institutions and credit unions, respectively. Chapter 4 discusses similar capital requirements for mortgage companies. This chapter discusses the related financial statement disclosures and auditing guidance. Finance companies are not subject to regulatory capital requirements.

Banks and Savings Institutions

Introduction

17.02 Banks are organized with capital stock and shareholders. Savings institutions operate under a capital stock structure, like banks, or a cooperative form of ownership, like credit unions. Savings institutions operating under the cooperative form are referred to as "mutual institutions." Although mutual institutions may be incorporated, they issue no capital stock and have no stockholders. The equity section of a mutual institution's statement of financial condition generally consists only of retained earnings and the accumulated other comprehensive income under FASB Statement No. 130. The equity section for banks and stock savings institutions additionally include common stock and additional paid-in capital.

Equity

17.03 ***Common Stock.*** Common stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest.

17.04 ***Preferred Stock.*** Preferred stock has certain privileges over common stock, such as a first claim on dividends. Typically, preferred stock conveys no voting rights, or only limited voting rights, to the holders. The rights of preferred stockholders are described in the articles of incorporation.

17.05 ***Additional Paid-In Capital.*** Amounts paid in the excess of par are additional paid-in capital. Absent such a stated par value, the bank or savings institution will assign a nominal par value to capital stock. Adjustments for treasury stock transactions, stock-based compensation and capital contributions may also be included in additional paid-in capital.

17.06 ***Retained Earnings.*** Retained earnings include undivided earnings and other appropriations as designated by management or regulatory authorities. Undivided earnings include the transfer of net income, declaration of dividends and transfers to additional paid-in capital.

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* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

17.07 ***Accumulated Other Comprehensive Income.*** In accordance with FASB Statement No. 130, banks and savings institutions are required to transfer the total of other comprehensive income for a period to a separate component of equity until realized. For example, other comprehensive income would include unrealized holding gains and losses on available-for-sale securities and the effective portion of the accumulated change in fair value on cash flow hedges. Declines in the fair values of investments that are other than temporary and the ineffective portion of cash flow hedges should be charged directly to operations.

Holding Company Equity and Regulatory Capital

17.08 ***Trust Preferred Securities.*** Trust preferred securities have been issued by banks for a number of years due to favorable regulatory capital treatment. Various trust preferred structures have been developed involving minor differences in terms. Under the typical structure, a bank holding company first organizes a business trust or other special purpose entity. This trust issues two classes of securities: common securities, all of which are purchased and held by the bank holding company, and trust preferred securities, which are sold to investors. The trust's only assets are deeply subordinated debentures of the corporate issuer, which the trust purchases with the proceeds from the sale of its common and preferred securities. The bank holding company makes periodic interest payments on the subordinated debentures to the business trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. The subordinated debentures have a stated maturity and may include an embedded call option. Most trust preferred securities are subject to a mandatory redemption upon the repayment of the debentures.

17.09 Under the provisions of FASB Interpretation No. 46 (revised December 2003) (FIN 46(R), *Consolidation of Variable Interest Entities*,[1,2,3] a

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[1] Application of FIN No. 46 (R) is required for public entities that have interests in entities commonly referred to as variable interest entities. Application by small business issuers to *variable interest entities* other than *special-purpose entities* and by nonpublic entities to all types of *variable interest entities* was required at various dates in 2004 and 2005.

[2] The FASB issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs, FIN 46(R), FSPs FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 have been replaced by FIN 46-2, FIN 46-5, and FIN 46-8, respectively, with the effective dates and transition provisions applying accordingly.

5. FIN 46(R)-5, "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*" (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) For entities to which Interpretation

(continued)

bank or holding company that sponsored a structure described above should not consolidate the trust because the trust is a variable interest entity and the bank or holding company is not the primary beneficiary of that entity.

17.10 An entity is a variable interest entity if its equity investment at risk (*a*) is insufficient to support its activities or (*b*) does not provide its holders with all the characteristics of a controlling financial interest. The trust's common equity investment is not at risk because the investment was financed by the trust through the purchase of the debentures. If the preferred stock is not classified as equity for GAAP reporting purposes, then the trust has no equity investment at risk and is a variable interest entity under paragraph 5(a) of FIN 46(R). Even if the preferred stock were classified as equity, the trust typically would be a variable interest entity under paragraph 5(b)(1) of FIN 46(R) because the holders of the equity investment at risk lack one of the characteristics of a controlling financial interest; that is, decision making ability through voting or similar rights. A variable interest entity is consolidated by its primary beneficiary, which is the variable interest holder with the obligation to absorb a majority of the entity's economic risks (expected losses) or the right to receive a majority of the entity's economic rewards (expected residual returns). In the typical trust preferred arrangement, the bank holds no variable interest in the trust, and therefore, cannot be the trust's primary beneficiary.[4] If the bank or holding company does not consolidate the trust, the bank or holding company should report its debt issued to the trust and an equity-method investment in the common stock of the trust.

(footnote continued)

46(R) has been applied, the guidance in this FSP was applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) is permitted but not required. Early application was permitted for periods for which financial statements were not yet issued. For entities to which Interpretation 46(R) had not been applied, the guidance in this FSP was applied in accordance with the effective date and transition provisions of Interpretation 46(R).

6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*." Effective for all arrangements to which FIN 46 had been applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change would have been reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).

7. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No.46(R)" An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

[3] For additional assistance, refer to the AICPA's Technical Practice Aid (TPA) 1400.29, "Consolidated Versus Combined Financial Statements under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*" (www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf).

[4] Paragraph B16 of FIN 46(R) states, "For the purpose of identifying variable interests, an embedded derivative that is clearly and closely related economically to its asset or liability host is not to be evaluated separately." Therefore, under FIN 46(R), such an embedded call option is not a variable interest in the trust.

17.11 ***Regulatory Capital Treatment of Trust Preferred Securities.*** On October 21, 1996, the Federal Reserve Board approved the use of certain cumulative preferred stock instruments in tier 1 capital for bank holding companies. On March 1, 2005, the Federal Reserve issued *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital* (12 CFR Parts 208 and 225 [Regulations H and Y; Docket No. R-1193]). Effective April 11, 2005, this rule allows the continued limited inclusion of trust preferred securities in the tier 1 capital of bank holding companies. Under this rule, trust preferred securities and other restricted core capital elements are subject to stricter quantitative limits. Prior to the rule, the amount of trust preferred securities, together with other cumulative preferred stock that a bank holding company could include in tier 1 capital was limited to 25 percent of tier 1 capital. This rule limits restricted core capital elements to 25 percent of all core capital elements, net of goodwill less any associated deferred tax liability. Internationally active bank holding companies, defined as those with consolidated assets greater than $250 billion or on-balance-sheet foreign exposure greater than $10 billion, will be subject to a 15 percent limit. They may include qualifying mandatory convertible preferred securities up to the generally applicable 25 percent limit. Amounts of restricted core capital elements in excess of these limits generally may be included in tier 2 capital. The rule provides a five-year transition period, ending March 31, 2009, for application of the quantitative limits.

17.12 The requirement for trust preferred securities to include a call option has been eliminated, and standards for the junior subordinated debt underlying trust preferred securities eligible for tier 1 capital treatment have been clarified. The rule also addresses supervisory concerns, competitive equity considerations, and the accounting for trust preferred securities. The rule also strengthens the definition of regulatory capital by incorporating longstanding Board policies regarding the acceptable terms of capital instruments included in banking organizations' tier 1 or tier 2 capitals.

17.13 ***Mandatory Redeemable Preferred Stock.*** Banks may issue mandatorily redeemable preferred stock as part of their capital structure. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*,[5] requires that mandatorily redeemable preferred stock be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. FASB Statement No. 150 does not permit presentation within a category between liabilities and equity (mezzanine presentation) if the stock is mandatorily redeemable. However, FASB Statement No. 150 does not address redeemable preferred stock that is conditionally redeemable (for example, stock that is

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[5] The staff of the FASB issued FSP FAS 150-2, "Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*." This FSP was effective immediately for freestanding financial instruments issued by entities to which the requirements of FASB Statement No. 150 have already been applied. The guidance should be applied for other entities as part of the adoption of FASB Statement No. 150. If this guidance results in changes to previously reported information, the cumulative effect should be reported according to the provisions of FASB Statement No. 150. In addition, the staff of the FASB also issued FSP FAS 150-5, *Issuer's Accounting under Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*. The guidance in this FSP should be applied to the first reporting period beginning after June 30, 2005. If the guidance in this FSP results in changes to previously reported information, the cumulative effect shall be reported according to the transition provisions of FASB Statement No. 150 in the first reporting period beginning after June 30, 2005.

putable by the holder at a specified date.) Mezzanine presentation would continue to apply for conditionally redeemable stock that is not in the scope of FASB Statement No. 150. FASB Staff Position (FSP) No. FAS 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," deferred the effective date of FASB Statement No. 150 for certain specific types of mandatorily redeemable financial instruments issued by nonpublic entities that are not SEC registrants and for certain mandatorily redeemable noncontrolling interests. If mandatorily redeemable shares are subject to the deferral under FASB FSP No. FAS 150-3,[6] the guidance in the Securities and Exchange Commission Regulation S-X, section no. 210.5-02.28 is applicable. This regulation states that mandatory redeemable preferred stock is not to be included in amounts reported as stockholders' equity. Although nonpublic companies are not required to follow Regulation S-X, it would be appropriate for them to do so in most cases.

17.14 ***Bank Holding Companies Under $150 Million in Assets.*** The Board of Governors of the Federal Reserve System has adopted a minimum ratio of Tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies regulated by the Federal Reserve. The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless the parent is engaged in a nonbank activity involving significant leverage or the parent company has a significant amount of outstanding debt that is held by the general public.[†]

Disclosures for Banks and Savings Institutions

17.15 Noncompliance with regulatory capital requirements could materially affect the economic resources of a bank or savings institution and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the footnotes to the financial statements:[7]

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) established by the prompt corrective action provisions of Section 38 of the FDI Act

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[6] FSP No. 150-3 deferred the effective date of FASB Statement No. 150 for mandatorily redeemable financial instruments issued by nonpublic entities that are *not* Securities and Exchange Commission (SEC) registrants, as follows:

a. For instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index, the classification, measurement, and disclosure provisions of FASB Statement No. 150 are effective for fiscal periods beginning after December 15, 2004.

b. For all other financial instruments that are mandatorily redeemable, the classification, measurement, and disclosure provisions of FASB Statement No. 150 are deferred indefinitely pending further Board action. During that indefinite deferral, the Board plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those instruments in conjunction with the Board's ongoing project on liabilities and equity.

[†] In February 2006 the Federal Reserve Bank issued a final rule expanding the definition of a small bank holding company. Refer to the Federal Reserve Web site for additional information.

[7] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

2. The actual or possible material effects of noncompliance with such requirements
3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented,[8] the following with respect to quantitative measures:[9,10]
   a. The institution's required and actual ratios and amounts of Tier 1 leverage, Tier 1 risk-based, and total risk-based capital, (for savings institutions) tangible capital, and (for certain banks and bank holding companies) Tier 3 capital for market risk
   b. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates
4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified as of its most recent notification[11]
5. As of the most recent balance sheet date, whether management believes any conditions or events since notification have changed the institution's category

17.16 If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements or (*b*) considered less than adequately capitalized under the prompt corrective action provisions or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.[12] Further, noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

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[8] For "adequately capitalized" or "undercapitalized" institutions, this disclosure should present the minimum amounts and ratios the institution must have to be categorized as *adequately capitalized* under the prompt corrective action framework and should include the effect of any supervisory action that has been imposed.

[9] These amounts may be presented in either narrative or tabular form.

[10] The percentages disclosed should be those applicable to the entity. Institutions with CAMELS ratings of 1 that are not anticipating or experiencing significant growth and have well-diversified risk are required to maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions. Also, if the institution has been advised that it must meet capital adequacy levels that exceed the statutory minimums, those higher levels should be disclosed. Such institution-specific requirements also should be the basis for management's assertion in disclosure item 3 about whether the institution is in compliance.

[11] A bank or savings institution is (under federal regulations) deemed to be within a given capital category as of the most recent date (*a*) the institution filed a regulatory financial report, (*b*) a final regulatory examination report is delivered to the institution, or (*c*) the institution's primary regulator provides written notice of the institutions' capital category or that the institution's capital category has changed.

[12] The institution should consider also making such disclosures when one or more of the institution's actual ratios is nearing noncompliance or when capital adequacy restrictions are imposed by regulation.

- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

17.17 Other regulatory limitations may exist despite compliance with minimum regulatory capital requirements. To the extent such limitations could materially affect the economic resources of the institution and claims to those resources, they should similarly be disclosed in the footnotes to the financial statements.

Disclosure for Holding Companies

17.18 The disclosures required by paragraphs 17.15, 17.16, and 17.17 should be presented for all significant subsidiaries of a holding company. Bank holding companies should also present the disclosures required by paragraphs 17.15, 17.16, and 17.17 as they apply to the holding company, except for the prompt corrective action disclosure required by item 4 in paragraph 17.15. Savings institution holding companies are not subject to regulatory capital requirements separate from those of their subsidiaries. Bank holding companies are not subject to the prompt corrective action provisions of the FDI Act.

Illustrative Disclosures for Banks and Savings Institutions (The Example Disclosures That Follow Are for Illustrative Purposes Only)

17.19 ***Well Capitalized.*** Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself *well capitalized* under the prompt corrective action framework. Comparative disclosures should be included for each balance sheet presented.

> The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.
>
> Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios

(set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined).[13] Management believes, as of December 31, 200X, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 200X, and December 31, 200W, the most recent notification from [*institution's primary regulator*] categorized the Bank as [*well capitalized*] under the regulatory framework for prompt corrective action. To be categorized as [*well capitalized*] the Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage ratios as set forth in the table.[14] There are no conditions or events since that notification that management believes have changed the institution's category.

17.20 ***Adequately Capitalized.*** Following is an illustrative paragraph to be added to the disclosures illustrated in paragraph 17.19 when an institution considers itself *adequately capitalized*:

Under the framework, the Bank's capital levels do not allow the Bank to accept brokered deposits without prior approval from regulators [*describe the possible effects of this restriction*].

17.21 ***Undercapitalized.*** Following are illustrative paragraphs to be added to the disclosures illustrated in paragraphs 17.19 and 17.20 when an institution considers itself *undercapitalized*. For a discussion about the independent accountant's consideration of noncompliance, see paragraph 5.193.

The Bank may not issue dividends or make other capital distributions, and may not accept brokered or high rate deposits, as defined, due to the level of its risk-based capital. [*Describe the possible effects of these restrictions*.]

Under the regulatory framework for prompt corrective action, the Bank's capital status may preclude the Bank from access to borrowings from the Federal Reserve System through the discount window. [*Describe the possible effects of these restrictions*.] Also, as required by the framework, the Bank has a capital plan that has been filed with and accepted by the Federal Deposit Insurance Corporation (FDIC). The plan outlines the Bank's steps for attaining the required levels of regulatory capital. Management believes, at this time, that the Bank will meet all the provisions of the capital plan and all the regulatory capital requirements by December 31, 200Y (or earlier if stated in the capital plan). [*The disclosure should continue with discussion of management plans such as reducing the size of the institution by converting noncash assets and reducing liabilities, issuing additional equity securities, or other plans for financial restructuring*.]

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[13] See footnote 10 in this chapter.

[14] Paragraphs 1.36–1.46 describe the prompt corrective action ratios. For some institutions, the calculation of required amounts and ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

17.22 ***Banks.*** Following is an illustrative table for presentation in financial statements for a bank's actual capital amounts and ratios as of the balance sheet date. All disclosures required by paragraph 17.15 should be presented.

	Actual		*For Capital Adequacy Purposes* [1]		*To Be Well Capitalized Under Prompt Corrective Action Provisions* [2]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Tier 1 Capital [3] (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	6.0%
Tier 1 Capital (to Average Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%

[1] See footnote 13 in this chapter.

[2] For adequately capitalized or undercapitalized institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive.

[3] See footnote 10 in this chapter.

17.23 ***Savings Institutions.*** Following is an illustrative table for presentation in financial statements for a savings institution's actual capital amounts and ratios as of the balance sheet date. All disclosures required by paragraph 17.15 should be presented.

	Actual		*For Capital Adequacy Purposes* [1]		*To Be Well Capitalized Under Prompt Corrective Action Provisions* [2]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	8.0%	$X,XXX,XXX	10.0%
Core Capital (to Adjusted Tangible Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	4.0%	$X,XXX,XXX	5.0%
Tangible Capital (to Tangible Assets)	$X,XXX,XXX	X.X%	$X,XXX,XXX	1.5%	N/A	
Tier 1 Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	N/A		$X,XXX,XXX	6.0%

[1] See footnote 14 in this chapter.

[2] For adequately capitalized or undercapitalized institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive.

17.24 ***Holding Companies.*** Following is an illustrative table for presentation in consolidated financial statements for a bank (or savings and loan association) holding company and each significant subsidiary as of the balance sheet date. Tier 3 capital market risk requirements are required to be disclosed only for certain banks and bank holding companies. All disclosures required by paragraph 17.15 should be presented except 17.15(4) disclosures related to prompt corrective action:

	Actual Amount	Actual Ratio	For Capital Adequacy Purposes [1] Amount	For Capital Adequacy Purposes [1] Ratio	To Be Well Capitalized Under Prompt Corrective Action Provisions [2] Amount	To Be Well Capitalized Under Prompt Corrective Action Provisions [2] Ratio
Total Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Tier 1 Capital (to Average Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**$X,XXX,XXX**	**X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%	$X,XXX,XXX	X.X%

[1] See footnote 14 in this chapter.

[2] For adequately capitalized or undercapitalized institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive.

Credit Unions

Introduction

17.25 Credit unions operate under a cooperative form of ownership. Members, in effect, "own" the credit union, although their interests in the credit union (that is, their shares) have the characteristics of deposits. Although the equity section of a credit union's statement of financial condition generally consists of retained earnings and accumulated other comprehensive income, generally accepted accounting principles require other items to be classified as equity.[15] As generally accepted accounting principles evolve, other items may also be included in members' equity. Retained earnings includes statutory reserves, retained earnings (sometimes referred to as 'undivided earnings') and other appropriations as designated by management or regulatory authorities. Although credit unions may be incorporated, no stock is issued. Retained earnings is generally shown as a single line item in the statement of financial condition. The components of retained earnings may be presented in the body of

[15] For example, in FASB's project, "Combinations between Mutual Enterprises," the Board has tentatively concluded that "in accounting for the acquisition of a mutual enterprise, the fair value of the acquired mutual enterprise taken as a whole should be reported in the financial statements of the acquirer as a direct addition to a capital or equity account and appropriately labeled and identified as capital or equity arising from the acquisition of a mutual enterprise." Accordingly, this item would be classified as members' equity although it is neither retained earnings nor other comprehensive income. The FASB Board expects the final statements on business combinations and noncontrolling interest to be issued by mid-2007. The target date for those statements will be determined near the end of redeliberations.

the statement of financial condition, the notes to the financial statements, or the statement of retained earnings. All appropriations and other restrictions of retained earnings should be disclosed.

Members' Equity

17.26 ***Regular Reserve (Statutory Reserve).*** The Federal Credit Union Act and certain states require that a regular (or statutory) reserve be established and maintained to provide an equity base for credit unions. The regular (or statutory) reserve account represents that required appropriation of equity. The regular (or statutory) reserve is established through a charge to undivided earnings and a credit to the reserve account. For federal credit unions, the amount required to be transferred is defined in sections 702.201 and 702.303 of the NCUA *Rules and Regulations*. The prompt corrective action rules describe the mandatory and discretionary prompt corrective actions that a credit union is subject to in cases where the credit union's capital level is below the "well capitalized" level, or the credit union fails to meet its required risk-based net worth requirement, or the credit union is subject to regulatory restrictions because of activities that are judged by the NCUA to be unsafe and unsound. In cases relating to inadequate capital with respect to the net worth requirement or the risk-based net worth requirement, a credit union is generally required to increase its net worth by the equivalent of at least 0.1 percent of assets each quarter until the credit union is classified as "well capitalized." The credit union must transfer that amount of earnings, or more by choice, from undivided earnings to the regular reserve until the credit union is classified as "well capitalized."

17.27 Certain states may have adopted similar regulations that apply to state-chartered credit unions. The statutes for each state should be consulted for applicable requirements.

17.28 The regular reserve should not be viewed as a substitute for or supplement to the allowance for loan losses. Loan losses and the provision for loan losses should not be charged directly to the regular reserve. The provision for loan losses and the allowance for loan losses should be accounted for in accordance with GAAP.

17.29 ***Undivided Earnings.*** Undivided earnings represent unappropriated accumulated earnings or losses of the credit union since its inception. The undivided earnings may also be increased or decreased as a result of transfers to or from appropriated accounts such as the regular reserve.

17.30 ***Appropriated Undivided Earnings.*** The board of directors of a credit union may restrict or appropriate portions of undivided earnings for specific purposes in accordance with paragraph 15 of FASB Statement No. 5. Examples include appropriations for loss contingencies and for major expenditures. The amount of such appropriations is normally transferred from undivided earnings, pending resolution of its purpose. Amounts appropriated may be returned to undivided earnings when they are no longer deemed necessary.

17.31 Federally-insured state chartered credit unions are required under terms of the insurance agreement to establish an investment valuation reserve, displayed as an equity classification, for held-to-maturity nonconforming investments. Nonconforming investments are those investments permissible under state law for a state-chartered credit union, but which are impermissible for federally chartered credit unions.

17.32 ***Other Components of Equity.*** Generally accepted accounting principles provide guidance for other items that should be classified as equity. As an illustration, in accordance with FASB Statement No. 130, credit unions are required to transfer the total of other comprehensive income for a period to a separate component of equity until realized. For example, other comprehensive income would include unrealized holding gains and losses on available-for-sale securities and the effective portion of the accumulated change in fair value of derivatives designated as cash flow hedges. Declines in the fair values of investments that are other than temporary and the ineffective portion of cash flow hedges should be charged directly to operations.

New Credit Unions and Low-Income Designated Credit Unions

17.33 The prompt corrective action regulations for credit unions designated as "new" are different than for other natural person credit unions. To be designated as "new" a credit union must have been in existence for less than 10 years and have less than $10 million in total assets. For credit unions designated as "low-income" by the NCUA, the net worth calculation includes certain uninsured, secondary capital accounts (as defined in the regulations).

Disclosures for Natural Person Credit Unions

17.34 Paragraph 16(*a*) of SOP 01-6 states: "Noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the notes to the financial statements:[16]

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) mandated by the prompt corrective action
2. The actual or possible material effects of noncompliance with such requirements
3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented, the following with respect to quantitative measures:
    - *a.* Whether the institution meets the definition of a complex credit union as defined by the National Credit Union Administration[17]
    - *b.* The institution's required and actual capital ratios and required and actual capital amounts
    - *c.* Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates
4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified

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[16] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

[17] The NCUA Board adopted prompt corrective action rules in response to the CUMAA requirement that the NCUA adopt a system to restore the net worth of inadequately capitalized federally insured credit unions. In conjunction with the adopted Prompt Corrective Action Rule, the NCUA Board also issued a rule, which defines a "complex" credit union and establishes risk-based net worth requirements. Readers should refer to the NCUA Regulations for the risk-based net worth and prompt corrective action requirements.

5. If, as of the most recent balance-sheet date or issuance of the financial statements, the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements
6. Whether subsequent to the balance sheet date and prior to issuance of the financial statements, management believes any events or changes have occurred to change the institution's prompt corrective action category."

17.35 If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements or (*b*) considered less than well capitalized under the prompt corrective action provisions or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.[18] Paragraph 16(*b*) of SOP 01-6 states: "Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities."

Illustrative Disclosures for Natural Person Credit Unions

17.36 ***Well Capitalized.*** The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself "*well capitalized*" under the prompt corrective action framework. Comparative disclosures should be included for each balance sheet presented.

> The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit

[18] The institution should consider also making such disclosures when the institution's actual ratio is nearing noncompliance.

Union's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth (as defined) to total assets (as defined). Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNW ratio as of December 31, 200X was __percent. The minimum ratio to be considered complex under the regulatory framework is 6 percent. Management believes, as of December 31, 200X, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 200X, the most recent call reporting period, the NCUA categorized the Credit Union as "*well capitalized*" under the regulatory framework for prompt corrective action. To be categorized as "*well capitalized*" the Credit Union must maintain a minimum net worth ratio of 7 percent of assets.[19] There are no conditions or events since that notification that management believes have changed the institution's category.

The Credit Union's actual capital amounts and ratios are also presented in the table.

	Actual		*To be Adequately Capitalized Under Prompt Corrective Action Provisions* [1]		*To be Well Capitalized Under Prompt Corrective Action Provisions*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
Net worth	$2,000,000	7.5%	$1,600,000	6.0%	$1,800,000	7.0%
Risk-Based Net Worth Requirement	$1,700,000	6.5%	N/A	N/A	N/A	N/A

[1] For "adequately capitalized" or "undercapitalized" institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as adequately capitalized under the prompt corrective action framework and should include the effect of any mandatory or discretionary supervisory actions.

Because the RBNWR, 6.5 percent, is less than the net worth ratio, 7.5 percent, the Credit Union retains its original category. Further, in performing its calculation of total assets, the Credit Union used the [*select one: average of the quarter-end balances of the four most recent quarters, monthly average over the quarter, daily average over the quarter, or quarter-end balance*] option, as permitted by regulation.

17.37 ***Adequately Capitalized.*** Following is an illustrative paragraph to be added in place of the third illustrative paragraph in paragraph 17.36

[19] Paragraphs 2.33–2.50 describe the prompt corrective action net worth ratios. For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

for an institution that is in compliance with capital adequacy requirements and considers itself "*adequately capitalized*" under the prompt corrective action framework:

> As of December 31, 200X, and December 31, 200W, the most recent call reporting period, the NCUA categorized the Credit Union as "adequately capitalized" under the regulatory framework for prompt corrective action. To be categorized as "adequately capitalized" the Credit Union must maintain a minimum net worth ratio of 6 percent of assets and, if applicable, must maintain adequate net worth to meet the Credit Union's risk-based net worth requirement of X percent as set forth in the table.[20] As an "adequately capitalized" credit union, the NCUA's prompt corrective action regulations require that the Credit Union to increase its net worth quarterly by an amount equivalent to at least 0.1 percent of its total assets for the current quarter, and must transfer that amount (or more by choice) from undivided earnings to its regular reserve account until it is "well capitalized," while continuing to meet its risk-based net worth requirement. There are no conditions or events since that filing date that management believes have changed the institution's category.

17.38 ***Undercapitalized.*** Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.36 when a credit union considers itself *undercapitalized* [for existing credit unions].

> The Credit Union may not increase assets and must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions*.] Under the regulatory framework for prompt corrective action, the Credit Union's net worth classification requires that a net worth restoration plan (NWRP) has been filed with and accepted by the National Credit Union Administration (NCUA). The plan outlines the Credit Union's steps for attaining the "adequately capitalized" level of net worth. Management believes, at this time, that the Credit Union will meet implement the steps and meet all the targets of the plan and all the regulatory net worth requirements by December 31, 200X (or earlier if stated in the restoration plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA*.]

17.39 ***New Credit Unions.*** Following are illustrative paragraphs to be added to the disclosures illustrated in paragraph 17.36 when a new credit union considers itself *moderately, marginally, minimally, or undercapitalized* [for new credit unions].

> The Credit Union must restrict member business loans due to its net worth. [*Describe the possible effects of these restrictions*.] Under the regulatory framework for prompt corrective action, a revised business plan has been filed, as required, with and accepted by the National Credit Union Administration (NCUA). The plan outlines the Credit Union's steps for attaining the required levels of net worth. Management believes, at this time, that the Credit Union will implement the steps and meet all the targets of the plan and all the

[20] For some institutions, the calculation of required amounts and net worth ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

regulatory net worth requirements by December 31, 200Y (or earlier if stated in the revised business plan). [*The disclosure should continue with discussion of any discretionary actions required by the NCUA*.]

Corporate Credit Unions

Introduction

17.40 Corporate credit unions operate under a cooperative form of ownership similar to natural person credit unions. Corporate credit unions are established to serve the financial needs of natural person credit unions that join the corporate. Although, the equity section of a corporate credit union's statement of financial condition generally consists of paid-in capital, retained earnings and accumulated other comprehensive income, generally accepted accounting principles require other items to be classified as equity.[21] As generally accepted accounting principles evolve, other items may also be included in members' equity. Retained earnings include all forms of retained earnings such as regular or statutory reserves and undivided earnings. Although some corporate credit unions may be incorporated under state laws, no stock is issued.

Equity

17.41 ***Membership Capital.*** Corporate credit unions are different from natural person credit unions in that they have specific membership capital accounts. Membership capital is comprised of funds contributed by the natural person credit unions, which are available to cover losses that exceed retained earnings and paid-in-capital. In the event of liquidation, membership capital is payable only after satisfaction of all other liabilities including uninsured deposits. These funds are not insured and can not be pledged. In general these funds have a minimum withdrawal notice of three years. Corporate credit unions may use either a term certificate for this account or an adjusted balance account, which is generally based on the assets of the member credit union.

17.42 ***Paid-in-Capital.*** Paid in capital is defined as the accounts or other interests that are available to cover losses that exceed reserves and undivided earnings. The NCUSIF or any other insurer does not insure these funds. These funds are callable only at the discretion of the corporate and only if the corporate meets the minimum capital and Net Economic Value (NEV)[22] requirements after the funds are called. Paid in capital includes both member and non-member paid-in-capital.[23]

17.43 ***Reserves and Undivided Earnings.*** Reserves and undivided earnings represent unappropriated accumulated earnings or losses of the corporate credit union since its inception. The accounting treatment of transactions in undivided earnings of a credit union is similar to that of transactions in retained earnings of corporate enterprises. The undivided earnings may also be increased or decreased as a result of transfers to or from appropriated accounts such as the regular reserve. Corporate credit unions are required to maintain

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[21] See footnote 16.

[22] Per NCUA regulation: "Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value for forward settlements and embedded options. The amortized portion of membership capital and paid-in capital, which do not qualify as capital, are treated as liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets."

[23] Auditors may need to be familiar with Part 704 of the NCUA Rules and Regulations to help assess the propriety and adequacy of financial statement disclosures.

a minimum capital ratio of 4 percent. To comply with this regulation, corporate credit unions calculate their capital ratio monthly. The capital ratio is the total corporate capital divided by the moving daily average net assets. The moving daily average net assets is calculated by the average of daily average net assets for the one month being measured and the previous 11 months.

17.44 When significant circumstances or events warrant, the OCCU Director may require a different minimum capital ratio for an individual corporate credit union based on its circumstances.

17.45 A corporate credit union must also maintain a minimum retained earnings ratio (2 percent for retail corporate credit unions and 1 percent for wholesale corporate credit unions). A retail corporate credit union must increase retained earnings if the prior month-end retained earnings ratio is less than 2 percent.

17.46 If the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is less than 3 percent, the earnings retention factor is .15 percent per annum; or if the prior month-end retained earnings ratio is less than 2 percent and the core capital ratio is equal to or greater than 3 percent, the earnings retention factor is .10 percent per annum. The core capital ratio is computed by dividing a corporate credit union's core capital (retained earnings and paid-in-capital) by its moving daily average net assets.

17.47 The monthly earnings retention amount is determined by multiplying the earnings retention factor by the prior month-end moving daily average net assets. The quarterly earnings retention amount is determined by multiplying the earnings retention factor by the moving daily average net assets for each of the prior three month-ends.

17.48 The minimum retained earnings ratio, core capital ratio, and related earnings retention requirements for wholesale corporate credit unions are outlined in Section 704.19 of the Final Rule, and in the illustration below.

17.49 ***Other Components of Equity.*** Generally accepted accounting principles provide guidance for other items that should be classified as equity. As an illustration, in accordance with FASB Statement No. 130, corporate credit unions are required to transfer the total of other comprehensive income for a period to a separate component of equity until realized. For example, other comprehensive income would include unrealized holding gains and losses on available-for-sale securities and the effective portion of the accumulated change in fair value of derivatives designated as cash flow hedges. Declines in the fair values of investments that are other than temporary and the ineffective portion of cash flow hedges should be charged directly to operations.

Disclosures for Corporate Credit Unions

17.50 Under current regulation, corporate credit unions are subject to regulatory capital requirements and not prompt corrective action. In applying the disclosure requirements of SOP 01-6, those prompt corrective action disclosures are not applicable for corporate credit unions. Paragraph 16(*a*) of SOP 01-6 states: "Noncompliance with regulatory capital requirements could materially affect the economic resources of a credit union and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the notes to the financial statements:[24]

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[24] Disclosures should also be presented for any state-imposed capital requirements that are more stringent than or significantly differ from federal requirements.

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) mandated by the prompt corrective action
2. The actual or possible material effects of noncompliance with such requirements
3. Whether the institution is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented, the following with respect to quantitative measures:
   a. Whether the institutions meets the definition of a complex credit union as defined by the National Credit Union Administration[25]
   b. The institution's required and actual capital ratios and required and actual capital amounts
   c. Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates
4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified
5. If, as of the most recent balance-sheet date or issuance of the financial statements, the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the financial statements
6. Whether subsequent to the balance sheet date and prior to issuance of the financial statements, management believes any events or changes have occurred to change the institution's prompt corrective action category."

17.51 If, as of the most recent balance sheet date presented, the institution is not in compliance with capital adequacy requirements, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be disclosed.[26]Paragraph 16(*b*) of SOP 01-6 states: "Noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the credit union's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.

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[25] The NCUA Board adopted prompt corrective action rules in response to the CUMAA requirement that the NCUA adopt a system to restore the net worth of inadequately capitalized federally insured credit unions. In conjunction with the adopted Prompt Corrective Action Rule, the NCUA Board also issued a rule, which defines a "complex" credit union and establishes risk-based net worth requirements. Readers should refer to the NCUA Regulations for the risk-based net worth and prompt corrective action requirements.

[26] The institution should consider also making such disclosures when the institution's actual ratio is nearing noncompliance.

- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities."

Illustrative Disclosures for Corporate Credit Unions

17.52 The example disclosures that follow are for illustrative purposes only. Comparative disclosures should be included for each balance sheet presented.

> The Corporate Credit Union is subject to various regulatory capital requirements administered by the National Credit Union Administration ("NCUA"). Failure to meet minimum capital requirements can initiate certain additional actions by regulators that, if undertaken, could have a direct material effect on the Corporate's financial statements.

NCUA Regulation 704 establishes a minimum capital ratio of 4 percent. A corporate credit union must maintain a minimum retained earnings ratio, or be subject to the earnings retention requirements of Section 704.3(i). The OCCU Director may approve a decrease to the earnings retention amount if it is determined a lesser amount is necessary to avoid a significant adverse impact upon a corporate credit union.

Retained Earnings Ratio	*Core Capital Ratio*	*Earnings Retention Requirement*
<2%	<3%	.15% per annum
<2%	= or >3%	.10% per annum
Wholesale Corporates:		
<1%	<3%	.15% per annum
<1%	= or >3%	.075% per annum

The corporate's capital ratios are as follows:

	200X
Actual:	
Capital	$ XXX
Capital Ratio	XXX%
Retained Earnings	$ XXX
Retained Earnings Ratio	XXX%
Core Earnings Ratio	XXX%
Required:	
Capital	$ XXX
Capital Ratio	4%
Retained Earnings	$ XXX
Retained Earnings Ratio	2% or 1%

The corporate's retained earnings ratio was X.X% and X.X% as of December 31, 200X. The corporate met the earnings retention requirements in accordance with regulatory provisions.

Mortgage Companies and Mortgage Banking Activities

Introduction

17.53 Mortgage companies are organized with capital stock and shareholders. Mortgage banking activities primarily consist of two separate but interrelated activities: (1) the origination or acquisition of mortgage loans for the purpose of selling those loans to permanent investors in the secondary market, and (2) the subsequent long-term servicing of those loans. Mortgage loans are acquired for sale to permanent investors from a variety of sources, including in-house origination and purchases from third-party correspondents. Certain common requirements are discussed in Chapter 4. For example, to participate in the Federal Housing Administration (FHA) mortgage insurance program, a mortgage lender must obtain, U.S. Department of Housing and Urban Development (HUD) approval by meeting various requirements prescribed by HUD, including maintaining minimum net worth requirements. Net worth requirements vary depending on the program. To obtain approval to sell and service mortgage loans for Fannie Mae and/or Freddie Mac, a mortgage lender must meet various requirements including maintaining an acceptable net worth.

Disclosure for Mortgage Companies and Mortgage Banking Activities

17.54 Paragraph 17(*a*) of SOP 01-6 states: "Noncompliance with minimum net worth (capital) requirements imposed by secondary market investors or state-imposed regulatory mandates could materially affect the economic resources of a mortgage banking entity and claims to those resources. To the extent an entity is subject to such requirements, the entity should disclose the following in the notes to the financial statements:

(1) A description of the minimum net worth requirements related to:

   (*a*) secondary market investors and

   (*b*) state-imposed regulatory mandates

(2) The actual or possible material effects of noncompliance with those requirements

(3) Whether the entity is in compliance with the regulatory capital requirements, including, as of each balance-sheet date presented, the following with respect to quantitative measures:

   (*a*) The entity's required and actual net worth amounts

   (*b*) Factors that may significantly affect adequacy of net worth such as potentially volatile components of capital, qualitative factors, or regulatory mandates

(4) If, as of the most recent balance-sheet date, the entity is not in compliance with capital adequacy requirements, the possible material effects of such conditions on amounts and disclosures in the notes to the financial statements."

17.55 Paragraph 17(*b*) of SOP 01-6 states: "Further, noncompliance with minimum net worth requirements may, when considered with other factors, raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- Possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including any relevant financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classifications of liabilities"

17.56 Paragraph 17(*c*) of SOP 01-6 states: "Servicers with net worth requirements from multiple sources should disclose, in the notes to the financial statements, the net worth requirement of the following:

(1) Significant servicing covenants with secondary market investors with commonly defined servicing requirements[27]

(2) Any other secondary market investor where violation of the requirement would have a significant adverse effect on the business

(3) The most restrictive third-party agreement if not included above"

Illustrative Disclosures for Mortgage Companies and Mortgage Banking Activities

17.57 The disclosures that follow are for illustrative purposes only, and represent a mortgage company that is in compliance with capital adequacy requirements. Comparative disclosures should be included for each balance sheet presented.

> The Company is subject to various capital requirements in connection with seller/servicer agreements that the Company has entered into with secondary market investors. Failure to maintain minimum capital requirements could result in the Company's inability to originate and service loans for the respective investor and, therefore, could have a direct material effect on the Company's financial statements. Management believes, as of December 31, 200X and 200W, that the Company met all capital requirements to which it is subject.
>
> The Company's actual capital amounts and the minimum amounts required for capital adequacy purposes, by investor, are as follows:

[27] At the time of issuance of SOP 01-6, common secondary market investors include the U.S. Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), and Federal Home Loan Mortgage Corporation (FHLMC).

	Actual Capital	Minimum Capital Requirement
As of December 31, 200X:		
HUD	$X,XXX,XXX	$XXX,XXX
FHLMC	$X,XXX,XXX	$ XX,XXX
FNMA	$X,XXX,XXX	$ XX,XXX

Regulatory Capital Matters for All Entities

Regulatory Capital Disclosures for Branches of Foreign Institutions

17.58 The disclosure requirements related to capital adequacy and prompt corrective action do not apply to branches of foreign organizations because such branches do not have capital. Paragraph A.51 of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, states: "Foreign branches, while they do not have capital requirements, are required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory-mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and, ultimately, going-concern questions. Accordingly, AcSEC believes that those foreign bank branches should disclose such requirements and the degree of compliance therewith."

17.59 Paragraph 15(*a*) of SOP 01-6 states: "Branches of foreign financial institutions, while they do not have regulatory capital requirements, may be required to maintain capital-equivalent deposits and, depending on facts and circumstances, supervisory-mandated reserves. These requirements carry regulatory uncertainty of a nature similar to that posed by the regulatory capital rules in that failure to meet such mandates can result in supervisory action and ultimately going-concern questions. Accordingly, branches should disclose such requirements. Quantitative disclosure should be made, highlighting mandated deposit or reserve requirements and actual balances in those reserve or deposit accounts at the balance-sheet date(s) reported. Further, if an uncertainty exists related to a parent that creates a higher-than-normal risk as to the viability of a branch or subsidiary, then that matter should be adequately disclosed in the notes to the financial statements of the branch or subsidiary. If factors do not exist that indicate a higher than normal amount of risk or uncertainty regarding parent capital and other regulatory matters, then disclosures of capital and supervisory issues of the parent would not be required."

Regulatory Capital Disclosures for Trust Operations

17.60 Paragraph A.52 of SOP 01-6 states: "Trust banks are required by certain federal regulators to hold capital as a percentage of discretionary and nondiscretionary assets under management. The percentages vary for each category. The percentages are not standardized as with other capital requirements and are communicated on an entity-by-entity basis in the application to obtain a trust charter or by other supervisory processes. Depending on the type of charter, these entities may be subject to risk-based standards as well. Because these are not published requirements, these guidelines are applied on a discretionary basis by the agencies and may not be uniformly applied to all entities. Because failure to meet capital requirements can have an adverse effect on the financial condition and results of operations of an entity, AcSEC concluded that, in cases in which these requirements are applied, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed."

17.61 Paragraph 15(*b*) of SOP 01-6 states: "If an institution is subject to capital requirements based on trust assets under management, a discussion of the existence of these requirements, ramifications of failure to meet them, and a measurement of the entity's position relative to imposed requirements should be disclosed in the notes to the financial statements."

Regulatory Capital Disclosures for Business Combinations

17.62 Paragraph 15(*d*) of SOP 01-6 states: "Following a business combination accounted for as a purchase, because prior capital position can be less relevant as a result of capital repatriation to former owners and the effects of purchase accounting adjustments and the push-down of basis, judgment should be used as to relevant disclosures. Minimum disclosures should include the capital position of the purchaser at the prior period end and information to highlight comparability issues, such as significant capital requirements imposed or agreed to during the regulatory approval process, and the effects of purchase accounting, if any, on regulatory capital determination."

Auditing

Banks, Savings Institutions and Credit Unions

Objectives

17.63 In addition to testing of disclosures, as discussed below, the independent accountant should consider the implications of capital noncompliance, as discussed beginning in paragraph 5.144 and in Chapter 22.

17.64 In addition to the normal objectives sought in auditing equity (for example balances are presented in accordance with GAAP), the independent accountant's objective in this area is to obtain reasonable assurance that the financial statements include proper and understandable description and disclosure of regulatory matters (as discussed earlier in this chapter) in the context of the financial statements taken as a whole. Similarly, the audit objective for regulatory capital matters relates primarily to disclosure.[28] Capital amounts determined under regulatory accounting principles (RAP) are, by definition, not recognized or measured in the institution's financial statements prepared in conformity with GAAP.

17.65 An independent accountant's report on financial statements containing the required regulatory capital disclosures does not constitute an opinion on the fair presentation of the institution's regulatory reports (in part or taken as a whole) in conformity with underlying instructions for such reports or RAP. Nor does the opinion indicate that the independent accountant has confirmed with any regulatory agency that the agency has examined or otherwise evaluated or opined on the fair presentation of such reports.

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[28] Notwithstanding the disclosure objective, regulatory matters may also affect preparation of the independent accountant's report, as discussed in Chapter 22.

Planning

17.66 In accordance with AU section 314, *Obtaining an Understanding of the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements,[29] which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to regulatory capital. Independent accountants should obtain an understanding of capital regulations sufficient to understand application and classification decisions made by management. The independent accountant should obtain audit evidence about the changes in regulatory reporting instructions and related capital requirements since the preceding audit.

17.67 Paragraphs 5.195 through 5.203 discuss the independent accountant's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of matters for disclosure.

17.68 While planning and carrying out procedures in other audit areas, the independent accountant should consider the potential that RAP-GAAP differences might result from the institution's transactions. This information will help the independent accountant assess differences (*a*) between GAAP equity amounts and RAP capital amounts and (*b*) between GAAP and RAP asset amounts, including risk weightings and off-balance-sheet equivalents. The information will also be useful for performing any procedures applied to such differences (including consideration of the relative risk weightings assigned to certain amounts or transactions).

17.69 In accordance with AU section 314, the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements as they relate to the adequacy of disclosure about regulatory matters. Some components of regulatory capital ratios, including related amounts, asset measures, and risk weightings, may be difficult to determine due to (*a*) the complexity and subjectivity of capital regulations and related regulatory reporting instructions or (*b*) the complexity of the institution's transactions. The number and variety of differences between GAAP and RAP amounts affecting the institution also will affect inherent risk in this area.

17.70 Management's regulatory financial reporting classification and risk weighting decisions involve a high degree of subjective analysis by management and might be challenged by examiners. Accordingly, such decisions that could have a material impact on regulatory disclosures should be carefully considered by the independent accountant.

17.71 The following are examples of factors related to regulatory matters that may indicate higher risks of material misstatement:

- A high volume and/or high degree of complexity of off-balance-sheet transactions
- Actual or borderline noncompliance with minimum capital requirements

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[29] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

- A poor regulatory rating
- Past disagreements between management and regulators about classifications, risk weightings, or other interpretations of RAP or application of capital regulations in general
- Frequent corrections to filed regulatory reports
- Regulatory restrictions or other regulatory actions taken related to capital compliance (for example, any MOU or LUA issued)
- Unusual, material, or frequent related party transactions
- Capital calculations, including management's classification or risk weighting decisions, that are not well documented

Internal Control Over Financial Reporting[30]

17.72 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

17.73 Effective internal control over financial reporting in this area should provide reasonable assurance that errors or fraud in financial statement disclosures about regulatory matters are prevented or detected. In part, these controls may overlap with controls the institution has established for compliance with capital requirements. Institutions' systems for gathering the necessary information and preparing regulatory financial reports vary in sophistication. Examples of factors that may contribute to effective internal control in this area follow.

- Responsibilities for capital planning, monitoring compliance with capital laws and regulations, and preparation of call reports have been assigned to competent individuals in the institution.
- Regulatory financial reporting is subject to risk assessment and supervisory control procedures and is overseen by officers of the institution who review the details supporting classifications and risk weightings.
- Capital amounts reported to regulators are reconciled to underlying detailed schedules and subsidiary ledgers with reconciling items supported by appropriate computations and documentation and with appropriate supervisory review and oversight.

[30] See footnote 1 in Chapter 5 regarding the applicability of PCAOB Standards.

- Procedures are in place for collection and reporting by branches, divisions, and subsidiaries of amounts necessary for regulatory capital calculations.
- Management obtains competent outside advice, as warranted, on significant classification or risk weighting questions before and after major transactions are executed.
- Regulatory capital analyses, calculations, and supporting documentation are well prepared and readily accessible.
- The regulatory financial reporting process (including classifications and risk weightings) is reviewed by the internal audit function.

17.74 ***Audits performed in accordance with PCAOB Standards.***[||] Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Refer to AU section 319.97 (AICPA, *PCAOB Standards and Related Rules*) for a discussion on the extent of test of controls. Also, refer to Appendix B in Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for guidance about tests to be performed when an institution has multiple locations or business units, the use of service organizations, and examples of extent-of-testing decisions.

Substantive Tests

17.75 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to bank, savings institutions and credit unions.

17.76 The extent to which the independent accountant applies tests to specific transactions or amounts will depend on the independent accountant's assessment of the risk of material misstatement and the materiality of the accounts. Where the risk of material misstatement is assessed at lower levels, the independent accountant may consider testing a reconciliation of RAP-GAAP differences before year-end, reviewing classifications made for risk weighting purposes, reviewing examination findings, and testing material RAP-GAAP differences, risk weighting classifications, and ratio calculations in preparation for any substantive tests to be applied to disclosures of year-end amounts and ratios.

17.77 For credit unions, the auditor should be satisfied that regular reserve transfers have been made in accordance with regulatory requirements. To gain such satisfaction, the auditor should obtain an understanding about of the applicable federal and state laws and regulations. Other entries, including direct charges and credits in accordance with regulatory requirements, should be tested for propriety. Other appropriations of net "retained earnings" should

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[||] In December 2006, the PCAOB proposed Release No. 2006-007, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, and Related Other Proposals*, that would supersede AS2 and all other previous PCAOB guidance related to that standard. See the PCAOB Web site at www.pcaobus.org for information about the effective dates of PCAOB Auditing Standard No. 2 and related conforming amendments to the PCAOB Standards.

be traced to authorization by the board of directors. Certain changes to the regular reserve are subject to regulatory approval and the auditor should be familiar with these requirements.

17.78 Chapters 1 and 2 discuss the independent accountant's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of the adequacy of the financial statement disclosures in this area.

17.79 Substantive procedures should be designed to the extent considered necessary to assess computations of regulatory capital amounts and asset measures by obtaining reasonable assurance that the underlying data are materially complete. Such procedures might include the following.

- Obtain and test management's schedules supporting calculation of the institution's actual and required regulatory capital ratios, including regulatory capital amounts (ratio numerators) and related asset bases (ratio denominators).
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on regulatory capital.
- Inquire about, and discuss with officers having responsibility for regulatory financial reporting, the existence and nature of the institution's RAP-GAAP differences. Review copies of prior-year regulatory reports (and, as necessary, client's supporting working papers), and obtain management's analysis of classification issues concerning preparation of call reports, including risk weighting classifications assigned. In assessing the completeness of any reconciliation, consider the potential for other of the institution's transactions to produce standard RAP-GAAP differences.
- Obtain any reconciliation of amounts supporting the institution's regulatory capital ratio calculations to amounts in the institution's financial statements prepared in conformity with GAAP.[31]
  - — Test management's supporting schedules and reconciliations for completeness and mathematical accuracy.
  - — Agree GAAP amounts to general and/or subsidiary ledgers and obtain supporting schedules for non-GAAP amounts.
- Review the nature and amount of material non-GAAP amounts for propriety and consistency with prior years.
- Consider current treatment of items that resulted in past corrections or changes to regulatory financial reports.
- Consider whether significant changes in instructions for preparation of call reports have been applied to material transactions.
- Inquire about, and discuss with officers having responsibility for call reporting, any significant reclassification of transactions since the last filed regulatory report.

[31] See OTS letter to chief executive officers dated September 11, 1992.

Mortgage Companies and Activities

Objectives

17.80 The independent accountant's objective in this area includes the normal objectives sought in auditing equity (e.g., balances are presented in accordance with GAAP), including obtaining reasonable assurance that the financial statements include proper description and disclosure of capital matters in the context of the financial statements taken as a whole. In addition, the independent accountant should consider the implications of capital noncompliance.

Planning

17.81 Independent accountants should obtain an understanding about the capital requirements that the entity is subject to as a result of seller/servicer agreements entered into with investors, as well as capital requirements that may be imposed as a result of other business transactions such as borrowing arrangements. In connection with these requirements, it is important that the independent accountants understand the elements that constitute capital, as defined in the various agreements.

17.82 In obtaining audit evidence concerning the entity's capital requirements, the independent accountants should also be aware of any assurance services that are required of the independent accountants. In accordance with AU section 314, the independent accountant should obtain audit evidence about the factors influencing the risk of material misstatement, which are described in Chapter 5, as they relate to the adequacy of disclosure about capital matters.

17.83 The following are examples of factors related to capital matters that may indicate higher risk of material misstatement:

- Actual or borderline noncompliance with minimum capital requirements
- Communications or restrictions from investors regarding capital compliance issues
- Capital requirements and calculations that are not well documented

Internal Control Over Financial Reporting

17.84 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. Examples of factors that may contribute to effective internal control in this area follow:

- Responsibilities for capital planning and monitoring compliance with capital requirements have been assigned to competent officials in the company.
- Capital analyses, calculations and supporting documentation are well prepared and readily accessible.

Substantive Procedures

17.85 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to mortgage companies and its activities.

17.86 The extent to which the independent accountant applies tests to specific transactions or amounts will depend on the independent accountant's assessment of inherent and control risks and the materiality of the accounts.

17.87 Substantive procedures should be designed to the extent considered necessary to assess computations of capital amounts by obtaining reasonable assurance that the underlying data are materially complete. Such procedures might include the following:

- Obtain and read new seller/servicer agreements entered into during the period, or amendments to existing agreements, for capital requirements in effect
- Obtain and test management's schedules supporting calculation of the entity's actual and required capital amounts
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on capital
- Obtain any reconciliation of amounts supporting the entity's capital calculations to amounts in the entity's financial statements prepared in conformity with GAAP
- Test management's supporting schedules and reconciliations for completeness and mathematical accuracy
- Agree GAAP amounts to general and/or subsidiary ledgers

Chapter 18

Futures, Forwards, Options, Swaps, and Similar Financial Instruments*

Introduction

18.01 The following section provides a discussion about the economic uses of derivative instruments and hedging activities. For accounting guidance on those topics the practitioner should refer to FASB Statement No. 133, as amended and related FASB Statement No. 133 implementation issues.[1]

18.02 The financial instruments addressed in this chapter-futures; forward, swap, and option contracts; and other financial contracts with similar characteristics have become important financial management tools for banks and savings institutions. These instruments collectively are referred to in this chapter as derivatives which are defined for accounting purposes in FASB Statement No. 133, paragraph 6, as amended. This chapter provides background information on basic contracts, risks, and other general considerations to provide a context for related accounting and auditing guidance.

18.03 This chapter focuses on end uses of derivatives, rather than on the broader range of activities that includes the marketing of derivatives to others. Some banks and savings institutions, primarily large commercial banks, act as market makers or dealers in derivatives that are not traded under uniform rules through an organized exchange. The primary goals of those activities are to make a market and earn income on the difference between the bid and offer prices. Although the volume of transactions often causes individual exposures to offset each other, such activities may be subject to different permutations of risks and different accounting and auditing considerations.

Risks Inherent in Derivatives

18.04 Risks inherent in derivatives such as credit risk, market risk, legal risk, and control risk are the same as risks inherent in more familiar financial instruments. However, derivatives often possess special features such as

- Little or no cash outflows or inflows required at inception.
- No principal balance or other fixed amount to be paid or received.
- Potential risks and rewards substantially greater than the amounts recognized in the statement of financial position.

Also, many derivatives values are more volatile than those of other financial instruments potentially alternating between positive and negative values in a short period of time.

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* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] Issues addressed by the Derivative Implementation Group (DIG) and the status of related guidance can be found at the FASB's Web site at www.fasb.org. See footnote † in paragraph 18.67 for amendments to FASB Statement No. 133.

18.05 Given these features, a derivative's risks can be difficult to segregate because the interaction of such risks may be complex. This complexity is increased (*a*) when two or more basic derivatives are used in combination, (*b*) by the difficulty of valuing complex derivatives, and (*c*) by the volatile nature of markets for some derivatives. The economic interaction between an institution's position in derivatives and that institution's other on- or off-balance-sheet positions (whether assets or liabilities) is an important determinant of the total risk associated with an institution's derivatives use. Risk assessment, therefore, involves consideration of the specific instrument and its interaction with other on- and off-balance-sheet portfolios and activities. There is no list of risk characteristics that can cover all those complex interactions, but a discussion of the basic risk characteristics associated with derivatives follows.

18.06 ***Credit Risk.*** This risk relates to the economic losses an institution would suffer if the party on the other end of the contract (the counterparty) fails to meet its financial obligations under the contract. Entities often quantify this risk of loss as the derivative's replacement cost -that is, the current market value of an identical contract. The requirement that participants settle changes in the value of their positions daily mitigates the credit risk of many derivatives traded under uniform rules through an organized exchange (exchange-traded derivatives). *Settlement risk* is the related exposure that a counterparty may fail to perform under a contract after the institution has delivered funds or assets according to its obligations under the contract. Institutions can reduce settlement risk through master netting agreements. *Counterparty risk* connotes the exposure to the aggregate credit risk posed by all transactions with one counterparty.

18.07 ***Market Risk.*** This risk relates broadly to economic losses due to adverse changes in the fair value of the derivative. Related risks include price risk, basis risk, and liquidity risk. *Price risk* relates to changes in the level of prices due to changes in (*a*) interest rates, (*b*) foreign exchange rates, or (*c*) other factors that relate to market volatilities of the rate, index, or price underlying the derivative. *Basis risk* relates to the differing effect market forces have on the performance or value of two or more distinct instruments used in combination (see the discussion of hedging that follows). *Liquidity risk* relates to changes in the ability to sell, dispose of, or close out the derivative, thus affecting its value. This may be due to a lack of sufficient contracts or willing counterparties. *Valuation or model risk* is the risk associated with the imperfection and subjectivity of models and the related assumptions used to value derivatives.

18.08 ***Legal Risk.*** This risk relates to losses due to a legal or regulatory action that invalidates or otherwise precludes performance by the institution or its counterparty under the terms of the contract or related netting arrangements. Such risk could arise, for example, from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities (such as certain state and local governmental entities) from investing in certain types of financial instruments.

18.09 ***Control Risk.*** This risk relates to losses that result from the failure (or absence) of internal controls to prevent or detect problems (such as human error, fraud, or system failure) that hinder an institution from achieving its operational, financial reporting, or compliance objectives. Such failure could result, for example, in an institution failing to understand a contract's economic characteristics. Lack of adequate control also could affect whether published financial information about derivatives was prepared reliably by a failure to prevent or detect misstatements caused by error or fraud in financial reporting. Finally, the institution may be negatively affected if controls fail to prevent or detect instances of noncompliance with related contracts, laws, or regulations. Failure to understand derivatives used may lead to inadequate design of controls over their use.

Types of Derivatives (Note That for Accounting Purposes, Derivatives Are Defined in Paragraph 6 of FASB Statement No. 133, as Amended)

18.10 A key feature of derivatives, as defined in this chapter, is that resulting cash flows are decided by reference to—

a. Rates, indexes (which measure changes in specified markets), or other independently observable factors.

b. The value of underlying positions in the following:

- Financial instruments such as government securities (interest-rate contracts), equity instruments (such as common stock), or foreign currencies
- Commodities such as corn, gold bullion, or oil
- Other derivatives

18.11 Derivatives can generally be described as either *forward-based or option-based*, or there can be combinations of the two. A traditional forward contract obligates one party to buy and a counterparty to sell an underlying financial instrument, foreign currency, or commodity at a future date at an agreed-upon price. Thus, a *forward-based derivative* (examples are futures, forward, and swap contracts) is a two-sided contract in that each party potentially has a favorable or unfavorable outcome resulting from changes in the value of the underlying position or the amount of the underlying reference factor. A traditional option contract provides one party that pays a premium (the option holder) with a right, but not an obligation, to buy (call options) or sell (put options) an underlying financial instrument, foreign currency, or commodity at an agreed-upon price on or before a predetermined date. The counterparty (the option writer) is obligated to sell (buy) the underlying position if the option holder exercises the right. Thus, *an option-based derivative* (examples are option contracts, interest rate caps, interest-rate floors, and swaptions) is one-sided in the sense that, in the event the right is exercised, only the holder can have a favorable outcome and the writer can have only an unfavorable outcome. If market conditions would result in an unfavorable outcome for the holder, the holder will allow the right to expire unexercised. The expiration of the option contract results in a neutral outcome for both parties (except for any premium paid to the writer by the holder). Although there are a variety of derivatives, they generally are variants or combinations of these two types of contracts.

18.12 Derivatives also are either exchange-traded or over-the-counter (OTC). Institutions and dealers trade futures, certain option, and other standardized contracts under uniform rules through an organized exchange. Most of the risk inherent in such exchange-traded derivatives relates to market risk rather than to credit risk. OTC derivatives are privately traded instruments (primarily swap, option, and forward contracts) customized to meet specific needs and for which the counterparty is not an organized exchange. As a result, although OTC derivatives are more flexible, they potentially involve higher credit and liquidity risk. The degree of risk depends on factors such as (*a*) the financial strength of the counterparty, (*b*) the sufficiency of any collateral held, and (*c*) the liquidity of the specific instrument. The advantages of OTC derivatives are that they can be customized and may be easier to use.

18.13 A description of the basic contracts and variations follows.

18.14 ***Forwards.*** *Forward contracts* are contracts negotiated between two parties to purchase and sell a specific quantity of a financial instrument, foreign currency, or commodity at a price specified at origination of the contract, with delivery and settlement at a specified future date. Forward contracts are not traded on exchanges and, accordingly, may be less liquid and generally involve more credit and liquidity risk than futures contracts.

18.15 *Forward-rate agreements*, which are widely used to manage interest-rate risk, are forward contracts that specify a reference interest rate and an agreed-upon interest rate (one to be paid and one to be received) on an assumed deposit of a specified maturity at a specified future date (the settlement date). The term of the assumed deposit may begin at a subsequent date; for example, the contract period may be for six months, commencing in three months. At the settlement date, the seller of the forward-rate agreement pays the buyer if interest calculated at the reference rate is higher than that calculated at the agreed-upon rate; conversely, the buyer pays the seller if interest calculated at the agreed-upon rate is higher than that calculated at the reference rate.

18.16 ***Futures.*** *Futures contracts* are forward-based contracts to make or take delivery of a specified financial instrument, foreign currency, or commodity at a specified future date or during a specified period at a specified price or yield. Futures are standardized contracts traded on an organized exchange. The deliverable financial instruments underlying interest-rate futures contracts are specified investment-grade financial instruments, such as U.S. Treasury securities or mortgage-backed securities (MBSs). *Foreign-currency futures contracts* involve specified deliverable amounts of a particular foreign currency. The deliverable products under *commodities futures contracts* are specified amounts and grades of commodities, such as oil, gold bullion, or coffee.

18.17 Active markets exist for most financial and commodities futures contracts. Active markets provide a mechanism by which entities may transfer their exposures to price risk to other parties. Those parties may, in turn, be trying to manage their own financial risks or achieve gains through speculation. Recognized exchanges, such as the International Monetary Market (a division of the Chicago Mercantile Exchange) or the Chicago Board of Trade, establish conditions governing transactions in futures contracts. U.S. Treasury bond (interest-rate) futures contracts are the most widely traded financial futures contracts. To ensure an orderly market, the exchanges specify maximum daily price fluctuations for each type of contract. If the change in price from the previous day's close reaches a specified limit, no trades at a higher or lower price are allowed. Consequently, trading in the contract is stopped until buy orders and sell orders can be matched either within the daily price limits or on the next business day. Such limits may affect liquidity and thereby hinder the effectiveness of futures contracts used as hedges.

18.18 Brokers require both buyers and sellers of futures contracts to deposit assets (such as cash, government securities, or letters of credit) with a broker. Such assets represent the initial margin (which is a good-faith deposit) at the time the contract is initiated. The brokers mark open positions to market daily and either call for additional assets to be maintained on deposit when losses are experienced (a margin call) or credit customers' accounts when gains are experienced. This daily margin adjustment is called *variation margin*. Variation margin payments generally must be settled daily in cash or acceptable collateral, thus reducing credit risk. The broker returns the initial margin when the futures contract is closed out or the counterparty delivers the underlying financial instrument according to the terms of the contract.

18.19 Delivery of the commodity or financial instrument underlying futures contracts occurs infrequently, as contracts usually are closed out before maturity. This close-out process involves the participants entering a futures contract that is equal and opposite to a currently held futures contract. This provides the participant with equal and opposite positions and obligations and eliminates any net obligation during the remaining lives of the futures contracts.

18.20 ***Swaps.*** *Swap contracts* are forward-based contracts in which two parties agree to swap streams of payments over a specified period. The payment streams are based on an agreed-upon (or notional) principal amount. The term *notional* is used because swap contracts generally involve no exchange of principal at either inception or maturity. Rather, the notional amount serves as a basis for calculation of the payment streams to be exchanged.

18.21 *Interest-rate swaps* are the most prevalent type of swap contract. One party generally agrees to make periodic payments, which are fixed at the outset of the swap contract. The counterparty agrees to make variable payments based on a market interest rate (index rate). Swap contracts allow institutions to achieve net payments similar to those that would be achieved if the institution actually changed the interest rate of designated assets or liabilities (the underlying cash position) from floating to fixed rate or vice versa.

18.22 Interest-rate swap contracts are considered a flexible means of managing interest-rate risk. Because swap contracts are customized for institutions, terms may be longer than futures contracts, which generally have delivery dates from three months to three years. Swap contract documentation usually is standardized and transactions can be concluded quickly, making it possible to rapidly take action against anticipated interest-rate movements.

18.23 Interest-rate swap contracts normally run to maturity. However, there may be circumstances that eliminate an institution's need for the swap contract before maturity. Accordingly, an institution may cancel contracts, sell its position, or enter an offsetting swap contract.

18.24 Swap contracts are not exchange-traded but negotiated between two parties. Therefore, they are not as liquid as futures contracts. They also lack the credit risk protection provided by regulated exchanges. The failure by a counterparty to make payments under a swap contract usually results in an economic loss to an institution only if the underlying prices (for example, interest rates or foreign exchange rates) have moved in an adverse direction; that is, in the direction that the swap contract was intended to protect against. The economic loss corresponds to the cost to replace the swap contract. That cost would be the present value of any discounted net cash inflows that the swap contract would have generated over its term.

18.25 In some swap contracts, the timing of payments varies. For example, in an interest-rate swap contract, one party might pay interest quarterly while the counterparty pays interest semiannually. An added element of credit risk exists for the quarterly payer because of the risk that the semiannual payer may default. Here, the economic loss equals the lost quarterly payment and the cost of replacing the swap contract.

18.26 Many entities enter legally enforceable master netting agreements that may reduce total credit risk. Upon default by an applicable counterparty, the agreements provide that entities may set off (for settlement purposes) all their related payable and receivable swap contract positions.

18.27 *Foreign-currency swaps* (sometimes called *cross-currency exchange agreements*) are used to fix (for example, in U.S. dollar terms) the value of foreign exchange transactions that will occur in the future. Foreign-currency swap contracts are also used to transfer a stream of cash flows denominated in a particular currency or currencies into another currency or currencies. Basic features of foreign-currency swap contracts include the following:

- The principal amount is usually exchanged at the initiation of the swap contract.
- Periodic interest payments are made based on the outstanding principal amounts at the respective interest rates agreed to at inception.
- The principal amount is usually re-exchanged at the maturity date of the swap contract.

18.28 In *fixed-rate-currency swaps*, two counterparties exchange fixed-rate interest in one currency for fixed-rate interest in another currency. Currency coupon or cross-currency interest-rate swap contracts combine the features of an interest-rate swap contract and a fixed-rate-currency swap contract. That is, the counterparties exchange fixed-rate interest in one currency for floating-rate interest in another currency.

18.29 *Basis swaps* are a variation on interest-rate swap contracts where both rates are variable but are tied to different index rates. For example, one party's rate may be indexed to three-month LIBOR while the other party's rate is indexed to six-month LIBOR.

18.30 *Equity swaps* are contracts in which the counterparties exchange a series of cash payments based on (*a*) an equity index and (*b*) a fixed or floating interest rate on a notional principal amount. Equity swap contracts typically are tied to a stock index, but sometimes they relate to a particular stock or a defined basket of stocks. One party (the equity payer) pays the counterparty (the equity receiver) an amount equal to the increase in the stock index at regular intervals specified in the contract. Conversely, the equity receiver must pay the equity payer if the stock index declines. The counterparties generally make quarterly payments. Whatever the index performance, the party designated as the equity receiver may also receive an amount representing dividends paid by the companies making up the index during the period.

18.31 The equity payer, on a floating-rate equity swap contract, typically receives LIBOR (plus or minus a notional spread) on the notional principal amount defined in the equity swap contract. This notional principal amount is based on the underlying equity index value at the contract's inception. The notional principal amount is adjusted at each payment date to reflect the settlement of the equity gain or loss. The floating rate is also reset on the periodic payment dates. A fixed-rate equity swap contract is essentially the same, except that the interest rate is fixed for the term of the contract.

18.32 *Commodity swaps* are contracts in which the counterparties agree to exchange cash flows based on the difference between an agreed-upon, fixed price and a price that varies with changes in a specified commodity index, as applied to an agreed-upon quantity of the underlying commodity.

18.33 In *mortgage swaps*, two counterparties exchange contractual payments designed to replicate the net cash flows of a portfolio of MBSs financed by short-term floating-rate funds. For example, mortgage swaps enable an institution to finance mortgage securities at a rate tied to a floating-rate index below LIBOR on a guaranteed, multiyear basis. Mortgage swaps have been described as being similar to an amortizing interest-rate swap (rather than one with a fixed notional principal amount) with a long-term forward commitment to purchase MBSs. In a typical mortgage swap transaction, an investor contracts with a third party to receive cash flows based on a generic class of MBSs over a specified period in exchange for the payment of interest at a rate typically based on LIBOR. The payments are made as if there were an underlying notional pool of mortgage securities. Payments are exchanged on a monthly basis. The cash flows received by the investor are derived not only from the fixed coupon on the generic class of securities but also, to the extent that the coupon is above or below par, from the benefit or loss implicit to the discount or premium. The notional amount of the mortgage swap is adjusted monthly, based on the amortization and prepayment experience of the generic class of MBSs.

18.34 The contract may require the investor either to take physical delivery of mortgages at a predetermined price (for example, a percentage of the par amount of mortgages remaining in the pool) when the contract expires or to settle in cash for the difference between the predetermined price of the mortgages and their current market value as determined by the dealer.

18.35 Credit risk for mortgage swaps is the possibility that the dealer will be unable to deliver the mortgages when the contract terminates. If the dealer cannot perform, and if the mortgages are selling above the original contract price at settlement, the investor suffers a loss and can also lose any margin or collateral retained by the dealer against the ultimate purchase of the mortgage securities. Similarly, the investor is also exposed to counterparty default risk on the interest-rate swap component of the transaction over the term of the contract.

18.36 At the time the mortgage swaps are initiated, the investor generally posts initial collateral with the dealer. Additional collateral is taken by the dealer or returned to the investor based on changes in the market price of the underlying mortgages. This two-way collateral policy reduces counterparty credit risk.

18.37 ***Options.*** *Option contracts* are traded on an exchange or over the counter (that is, they are negotiated between two parties). Option contracts allow, but do not require, the holder (or purchaser) to buy (call) or sell (put) a specific or standard commodity, or financial or equity instrument, at a specified price during a specified period (an American option) or at a specified date (a European option). Furthermore, certain option contracts may involve cash settlements based on changes in specified indexes, such as stock indexes. Again, the principal difference between option contracts and either futures or forward contracts are that an option contract does not require the holder to exercise the option, whereas performance under a futures or forward contract is mandatory.

18.38 At the inception of an option contract, the holder typically pays a fee, which is called a *premium*, to the writer (or seller) of the option. The premium includes two values, the intrinsic value and the time value. The *intrinsic value* of a call option is the excess, if any, of the market price of the item underlying the option contract over the price specified in the option contract (the strike price or the exercise price). The intrinsic value of a put is the excess, if any, of the option contract's strike price over the market price of the item underlying the option contract. The intrinsic value of an option cannot be less than zero. The other component of the premium's value is the time value. The *time value* reflects the probability that the price of the underlying item will move above the strike price (for a call) or below the strike price (for a put) during the exercise period.

18.39 The advantage of option contracts held is that they can be used to mitigate downside price risk without totally negating upside profit potential. This is because the loss on a purchased option contract is limited to the amount paid for the option contract. Profit on written option contracts is limited to the premium received but the loss potential is unlimited because the writer is obligated to settle at the strike price if the option is exercised.

18.40 Option contracts are frequently processed through a clearinghouse that guarantees the writer's performance under the contract. This reduces credit risk, much like organized exchanges reduce credit risk for futures contracts. Thus, such option contracts are primarily subject to market risk. However, for option contracts that are not processed through the clearinghouse, the holder may have significant credit and liquidity risks.

18.41 Different option contracts can be combined to transfer risks from one entity to another. Examples of such option-based derivatives are caps, floors, collars, and swaptions.

18.42 *Interest-rate caps* are contracts in which the cap writer, in return for a premium, agrees to limit, or cap, the cap holder's risk associated with an increase in interest rates. If rates go above a specified interest-rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Issuers of floating-rate liabilities often purchase caps to protect against rising interest rates while retaining the ability to benefit from a decline in rates.

18.43 Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. Because caps are not exchange-traded, however, they expose the cap holder to credit risk because the cap writer could fail to fulfill its obligations.

18.44 A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate. However, the cap writer's premium may potentially provide an attractive return.

18.45 *Interest-rate floors* are similar to interest-rate caps. Interest-rate floors are contracts in which the floor writer, in return for a premium, agrees to limit the risk associated with a decline in interest rates based on a notional amount. If rates fall below an agreed rate, the floor holder will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount. Floor contracts allow floating-rate lenders to limit the risk associated with a decline in interest rates while benefiting from an increase in rates. As with interest-rate caps, the floor holder is exposed to credit risk because the floor writer could fail to fulfill its obligations.

18.46 *Interest-rate collars* combine a cap and a floor (one held and one written). Interest-rate collars enable an institution with a floating-rate contract to lock into a predetermined interest-rate range.

18.47 *Swaptions* are option contracts to enter an interest-rate swap contract at some future date or to cancel an existing swap contract in the future. As such, a swaption contract may act as a floor or a cap for an existing swap contract or be used as an option to enter, close out, or extend a swap contract in the future.

Uses of Derivatives to Alter Risk

18.48 Financial market participants have created a large variety of derivatives. Not only are there basic contracts, but there are variants tailored to add, subtract, multiply, or divide the related risk and reward characteristics and thereby satisfy specific risk objectives of the parties to the transactions. Such innovation has been driven by the users' desire to cope with (or attempt to take advantage of) market volatility in foreign exchange rates, interest rates, and other market prices; deregulation; tax law changes; and other broad economic or business factors. An institution may attempt to alter such risks (*a*) at a general level (that is, the overall risk exposures faced by the institution), (*b*) at the level of specific portfolios of assets or liabilities, or (*c*) narrowly to a specific asset, liability, or anticipated transaction. Uses of derivatives to alter risks range from uses that help mitigate or control volatile risk exposures (activities that include the idea of taking defensive action against risk through hedging) to uses that increase exposures to risk and, by that, the potential rewards (the idea of offensive action, often considered as trading or speculation).

18.49 ***Speculation.*** *Speculation* involves the objective of profiting by entering into an exposed position, that is, assuming risk in exchange for the opportunity to profit from anticipated market movements. A speculator believes that the cash market price of an underlying commodity, financial instrument, or index will change so that the derivative produces net cash inflows or can be closed out in the future at a profit.

18.50 ***Risk Management.*** Some institutions use the volatility of derivatives to increase or decrease risks associated with existing or anticipated on- or off-balance sheet transactions. Institutions often manage financial risks both generally (through management of the overall mix of financial assets and liabilities) and specifically (through hedges of specific risks or transactions).

18.51 Some entities continually analyze and manage financial assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market prices or interest rates. Such activities fall under the broad definition of *asset/liability management*. Some institutions purchase derivatives to help manage and select their total exposure to interest-rate risk. Institutions also purchase derivatives to convert the cash flow pattern and market risk profile of assets and liabilities. Those instruments can be used in the institution's asset/liability management activities to synthetically alter the interest income and expense flows of certain assets or liabilities. For example, an institution can convert the cash flow pattern and market risk profile of floating-rate debt to those of fixed-rate debt by entering an interest-rate swap contract. (Note that synthetic instrument accounting is not allowed by FASB Statement No. 133, as amended).[2]

18.52 *Hedging* connotes a risk alteration activity to protect against the risk of adverse price or interest-rate movements on certain of an institution's assets, liabilities, or anticipated transactions. A *hedge* is a defensive strategy. It is used to avoid or reduce risk by creating a relationship by which losses on certain positions (assets, liabilities, or anticipated transactions) are expected to be counterbalanced in whole or in part by gains on separate positions in another market. For example, an institution may want to attempt to fix the value of an asset, the sales price of some portion of its future production, the rate of exchange for payments to its suppliers, or the interest rates of an anticipated issuance of debt.

18.53 The use of various financial instruments to reduce certain risks results in the hedger assuming a different set of risks. Effective control and management of risks through hedging, therefore, require a thorough understanding of the market risks associated with the financial instrument that is part of the hedging program.

18.54 *Basis risk* is an important risk encountered with most hedging contracts. As introduced above, basis is the difference between the cash market price of the instrument or other position being hedged and the price of the related hedging contract. The institution is subject to the risk that the basis will change while the hedging contract is open (that is, the price correlation will not be perfect). Changes in basis can occur continually and may be significant. Changes in basis can occur even if the position underlying the hedging contract is the same as the position being hedged. However, entities often enter a hedging contract, such as a futures contract, on a position that is different from the position being hedged. Such *cross-hedging* increases the basis risk.

18.55 As cash market prices change, the prices of related hedging contracts change, but not necessarily to the same degree. *Correlation* is the degree to which hedging contract prices reflect the price movement in the cash market. The higher the correlation between changes in the cash market price and the hedging contract's price, the higher the precision with which the hedging contract will offset the price changes of the position being hedged.

18.56 Gains or losses on the hedge position will not exactly offset the exposed cash market positions when the basis changes. The institution might enter a hedge when (*a*) it is perceived that the risk of a change in basis is lower than the risk associated with the cash market price exposure or (*b*) there is the ability to monitor the basis and to adjust the hedge position in response to basis changes.

18.57 Basis changes in response to many factors. Among them are (*a*) economic conditions, (*b*) supply and demand for the position being hedged,

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[2] See paragraph 18.67 for accounting and financial reporting under FASB Statement No. 133.

(*c*) liquidity of the cash market and the futures market for the instrument, (*d*) the credit rating of the cash instrument, and (*e*) the maturity of the instrument being hedged as compared with the instrument represented in the hedging contract. A discussion of how these factors affect basis is beyond the scope of this chapter. However, convergence—a significant contributor to a change in the basis over time—warrants mention.

18.58 *Convergence* is the shrinking of the basis between the hedging contract's price and the cash market price as the contract delivery date approaches. The hedging contract's price includes an element related to the time value up to the expiration of the contract. Convergence results from the delivery feature of hedging contracts that encourages the price of an expiring contract to equal the price of the deliverable cash market instrument on the day that the contract expires. As the delivery day approaches, prices generally fluctuate less and less from the cash market prices because the effect of expectations related to time is diminishing.

18.59 *The correlation factor* represents the potential effectiveness of hedging a cash market instrument with a contract where the deliverable financial instrument differs from the cash market instrument. The correlation factor generally is determined by regression analysis or another method of technical analysis of market behavior. When a high degree of positive correlation has historically existed between the hedging instrument price and the cash market price of the instrument being hedged, the risk of price variance associated with a cross-hedge is expected to be lower than the risk of not being hedged. Institutions usually employ the correlation factor to analyze cross-hedging risk at the inception of the hedge, while actual changes in the relative values of the hedge instrument and the hedged item usually are employed throughout the hedge period to measure correlation.

Variations on Basic Derivatives

18.60 Some derivatives combine two or more basic contracts and thereby the risk and reward characteristics of several different products. Written options and other variations embedded in certain derivative and nonderivative contracts can magnify interest-rate and other risks assumed by the institution as end user. Included may be variations affecting the term, notional amount, interest rate, or specified payments. These variations have the potential to produce higher cash inflows or outflows than similar instruments that do not contain the option feature. This follows the general rule that the greater the potential return, the higher the risk.

18.61 Some swap contracts involve the institution's writing of options that the counterparty issuer may exercise if certain changes occur in the index rate or under other specified circumstances. As with most option contracts (and allowing for the effect of the premium paid for the contract) the holder of the option (here, the counterparty) has a potentially favorable (or neutral) outcome, while the writer of the option (here, the institution) has a potentially unfavorable (or neutral) outcome if the option is exercised. For example, the counterparty will exercise an option to sell securities to the institution at a specified price only when that price exceeds the current market prices. Accordingly, the institution must analyze such contracts carefully to understand the nature of the derivative and how it will work under various interest-rate and other conditions.

18.62 ***Other Variations.*** Other variations built into derivatives may require the institution to take certain actions or may result in changes in terms if specified events or conditions occur. For example, such variations might involve—

- Increases or decreases in the notional amount based on certain changes in interest rates.
- Increases or decreases in interest rates based on a multiplier.
- Additional payments required under specified conditions.
- A settlement payment required upon the expiration of a contract.

18.63 Some swap contracts magnify changes in the specified index rate by tying floating payments to an exponent of the index rate over a specified denominator. The risks of this variation, a contract with embedded leverage terms, are similar to the risks posed by written options. Consider a contract that specifies the floating rate as three-month LIBOR squared and divided by 5 percent. Assume that three-month LIBOR is 5 percent at inception. Were three-month LIBOR to climb five basis points to 5.05 percent, the increase would be magnified. The floating rate would increase ten basis points to approximately 5.10 percent (5.05 percent squared and divided by 5 percent). Thus, at this level of interest rates, an increase of one basis point in the index rate for the contract would result in an increase of two basis points in the contractual rate—in other words, one basis point on twice the stated notional amount.

18.64 Finally, the notional principal amount of certain swap contracts changes with changes in the rate to which the floating payments are indexed. These are called index amortizing swaps. For example, the notional principal amount may decrease when interest rates decline. Thus, the floating-rate payer would lose some of the benefit of declining interest rates but would not get a corresponding benefit if interest rates increase.

Regulatory Matters

18.65 Chapter 7 discusses the regulatory matters affecting the permissibility of certain investments.

18.66 Banking Circular (BC) 277, issued by the Office of the Comptroller of the Currency (OCC), addresses banks' risk management of derivatives and sets forth best practices and procedures for managing risk. OCC Bulletin 94-31 answers commonly asked questions about BC 277. The Board of Governors of the Federal Reserve System (FRB) issued detailed guidance to its examiners for evaluating derivatives with respect to management oversight, measurements and monitoring procedures, and internal controls in Supervisory and Regulatory Letters (SR) 96-17, 97-18 and 98-13. The Federal Deposit Insurance Corporation (FDIC) issued guidance for its examiners in Financial Institutions Letter (FIL) 45-98. The OTS issued TB 13a, which provides guidance to management and boards of directors on management of interest rate risk, including the management of investment and derivative activities.

Accounting and Financial Reporting

18.67 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, established accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those investments at fair value. If certain conditions are met, a derivative may be specifically designated as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment (*b*) a hedge of the exposure to variable cash flows of a forecasted transaction, or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133, as amended, also contains extensive disclosure requirements. In addition, FASB Statement No. 133, as amended, clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Readers should refer to the full text of this Statement, as well as the body of interpretive literature contained in the Derivative Implementation Group (DIG) when considering accounting and reporting issues related to derivative instruments and hedging activities.[†]

18.68 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

18.69 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. FASB Statement No. 156 amended paragraphs 21 and 56 of FASB Statement No. 133. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

18.70 Accounting and reporting requirements for derivative instruments and hedging activities are also contained in a number of other pronouncements, which are presented below with a summary explanation of those pronouncements. Readers should refer to the full text of the pronouncements for guidance.

18.71 ***FASB Statement No. 107, as amended.*** FASB Statement No. 107 extended fair value disclosure practices for some instruments by requiring all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, FASB Statement No. 107 requires disclosure of descriptive information

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[†] The FASB recently issued an exposure draft that would amend FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The purpose of the amendment to Statement No. 133 is to expand disclosure requirements in order to enhance an understanding of an entity's use of derivative instruments and hedging activities. The comment period for this exposure draft ended on March 2, 2007. Readers should monitor the FASB Web site for upcoming developments.

pertinent to estimating the value of a financial instrument. Disclosures about fair value are not required for certain financial instruments. (See paragraph 8 of FASB Statement No. 107.) In addition FASB Statement No. 107 requires disclosures about concentrations of credit risk of all financial instruments.

18.72 FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an Amendment of FASB Statement No. 107*, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and by FASB Statement No. 149 *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*, amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Statements*, to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria specified in paragraph 2 of FASB Statement No. 126:

a. The entity is a nonpublic entity (as defined in FASB Statement No. 126).

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133 other than commitments related to the origination of mortgage loans to be held for sale during the reported period.

18.73 Paragraph 11 of FASB Statement No. 107 requires that fair values be estimated for financial instruments with no quoted prices. Paragraph 24 of the Statement suggests that an estimate of the fair value of a customized interest-rate swap or foreign currency contract might be based on the quoted market price of a similar financial instrument (adjusted as appropriate for the effects of the tailoring) or, alternatively, on the estimated current replacement cost of that instrument. Paragraph 25 of the Statement suggests that an estimate of the fair value of customized options (for example, put and call options on stock, foreign currency, or interest-rate contracts) may be valued using one of a variety of pricing models that are used regularly to value options.

18.74 ***FASB Interpretation No. 45.*** FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*[3] addresses the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees. This Interpretation also clarifies the requirements related to the recognition of a liability by a guarantor at the inception of a guarantee for the obligations the guarantor has undertaken in issuing that guarantee. As discussed in paragraph 12 of FASB Interpretation No. 45, this Interpretation does not specify the subsequent measurement of the guarantor's recognized liability for either the noncontingent aspect of the guarantee

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[3] In addition to FASB Interpretation No. 45, the FASB staff issued two FASB Staff Positions (FSP), FSP FIN 45-2, *Whether FASB Interpretation No. 45*, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value, that was effective immediately, and FSP FIN 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners*. FSP FIN 45-3 should be applied for new minimum revenue guarantees issued or modified on or after the beginning of the first fiscal quarter following November 10, 2005.

or the contingent aspect of the guarantee. These measurement requirements do not apply to those guarantees accounted for as derivatives because they are already required by FASB Statement No. 133 to be measured (initially and subsequently) at fair value. The disclosure requirements in FASB Interpretation No. 45 are applicable to guarantees that are derivatives subject to FASB Statement No. 133. The accounting for the contingent aspect of the guarantee, if it is not accounted for as a derivative under FASB Statement No. 133, is covered by FASB Statement No. 5, *Accounting for Contingencies*.

18.75 ***FASB Interpretation No. 39.*** Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines *right of setoff* and specifies what conditions must be met to have that right. It also addresses the applicability of that general principle to forward, interest-rate swap, currency swap, option, and other conditional or exchange contracts and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement. Appendix D-43 to the *EITF Abstracts* contains the FASB staff response to inquiries about the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

18.76 ***FASB Statement No. 104.*** FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, amended FASB Statement No. 95, Statement of Cash Flows, to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged, provided that accounting policy is disclosed. FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amended FASB Statement No. 95 to reflect cash flow reporting requirements for derivatives with significant embedded financings.

18.77 ***SEC Market Risk Disclosure Rules.***[4] Item 305 of Regulation S-K requires entities filing with the SEC to disclose certain information about market risk. In general, the rule:

a. requires quantitative and qualitative disclosures about market risk inherent in derivatives and other financial instruments outside the financial statements; and

b. provides a reminder to registrants to supplement existing disclosures about financial instruments, commodity positions, firm commitments, and other forecasted transactions with related disclosures about derivatives.

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[4] Readers should refer to the SEC Web site for the complete disclosure requirements under Regulation S-K and SAB No. 105 (http://sec.gov/divisions/corpfin/forms/regsk.htm#quan).

18.78 ***SEC Market Risk Disclosure Rules.*** SEC Staff Accounting Bulleting (SAB) No. 105,[5] *Application of Accounting Principles to Loan Commitments* (Codification of Staff Accounting Bulletins, Topic 5(DD)), for entities filing with the SEC, provides required valuation and disclosure guidance for loans commitments accounted for as derivatives entered into subsequent to March 31, 2004.

Auditing Considerations

18.79 AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), provides guidance on auditing investments in debt and equity securities, investments accounted for under APB Opinion No. 18, and derivative instruments and hedging activities. In addition, the companion Audit Guide to AU section 332 entitled *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementation on all types of audit engagements. The suggested auditing procedures contained in the guide do not increase or otherwise modify the auditor's responsibilities described in AU section 332. Rather, the suggested procedures in the Guide are intended to clarify and illustrate the application of the requirements of AU section 332. Practitioners should refer to the auditing considerations and requirements of AU section 332 and guidance contained in the related Audit Guide. In addition, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements.[6]

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[5] The AICPA has issued a Practice Aid, *Illustrative Disclosures on Derivative Loan Commitments*, for comment. The practice aid provides illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in SAB No. 105.

[6] For additional guidance refer to AICPA Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 and Interpretation No. 1, "Auditing Investments in Securities Were a Readily Determinable Fair Value Does Not Exist" of AU section 332, respectively.

Chapter 19

Business Combinations[*]

Introduction

19.01 Business combinations may involve one enterprise acquiring the equity interests or net assets of another enterprise or both enterprises transferring their equity interests or net assets to a newly formed enterprise. Business combinations involving depository institutions are increasingly common today and result from voluntary decisions as well as regulatory mandates. Most business combination issues are the same for depository institutions as for other business enterprises. This chapter addresses only significant issues that are unique to depository institutions.

Regulatory Matters

19.02 The Office of Thrift Supervision (OTS) requires the independent accountants for both the purchasing and selling institutions to opine on whether the transaction has been accounted for in conformity with generally accepted accounting principles (GAAP).

19.03 In certain circumstances, an acquired bank or savings institution uses the acquiring institution's basis of accounting in preparing the acquired institution's financial statements. These circumstances are addressed for Securities and Exchange Commission (SEC) registrants in the SEC's Staff Accounting Bulletin (SAB) No. 54, *Application of "Push Down" Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase*, codified by SAB No. 103, *Update and Codification of Staff Accounting Bulletins* (Codification of Staff Accounting Bulletins, Topic 5(J): *Push Down Basis of Accounting Required in Certain Limited Circumstances*). In the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 86-9, *IRC Section 338 and Push-Down Accounting*, the EITF reached a consensus that such push-down accounting is not required for companies that are not SEC registrants. However, the FFIEC *requires* push down accounting for Reports of Condition and Income if a direct or indirect change in control of at least 95 percent of the voting stock of the bank has occurred and the bank does not have an outstanding issue of publicly traded debt or preferred stock. Push down accounting is also required if the bank's separate financial statements are presented on a push down basis in reports filed with the SEC. Push down accounting *may* also be used when a direct or indirect change in control of at least 80 percent, but less than 95 percent of the voting stock of the bank has occurred. In all cases, the bank's primary supervisory authority reserves the right to determine whether or not a bank must use push down accounting for purposes of Reports of Condition and Income.

19.04 The SEC's SAB No. 82, *Certain Transfers of Nonperforming Assets: Disclosures of the Impact of Assistance From Federal Regulatory Agencies*, codified by SAB No. 103, *Update and Codification of Staff Accounting Bulletins* (Codification of Staff Accounting Bulletins, Topic 11(N): *Disclosures Of*

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

The Impact Of Assistance From Federal Financial Institution Regulatory Agencies (Topic 11(N)),[1] discusses accounting for transfers of nonperforming assets by financial institutions and disclosure of the impact of financial assistance from regulators. Topic 11(N) states the SEC staff's belief that users of financial statements must be able to assess the impact of credit and other risks on a company following a regulatory-assisted acquisition, transfer, or other reorganization on a basis comparable with that disclosed by other institutions, that is, as if the assistance did not exist. In that regard, the SEC staff believes that the amount of regulatory assistance should be separately disclosed and should be separately identified in the statistical information furnished pursuant to Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*, to the extent that it affects such information. Further, the nature, extent, and impact of such assistance should be fully disclosed in management's discussion and analysis.

19.05 In February of 2006 the FASB issued Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statement No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

19.06 In March of 2006 the FASB issued Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

19.07 The SEC's SAB No. 61, *Adjustments to Allowances for Loan Losses in Connection with Business Combinations*, discusses the limited circumstances whereby it may be appropriate to adjust the allowance for loan losses acquired in a business combination.

Accounting and Financial Reporting[2]

19.08 Accounting for business combinations involving financial institutions is similar to that for other enterprises.[†] FASB Statement No. 141, *Business*

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[1] The FASB has issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. Readers should monitor developments at www.fasb.org.

In November of 2005 the FASB staff issued FASB Staff Position (FSP) 140-2, "Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140". This guidance was effective immediately upon issuance. Guidance regarding unexpected events described in paragraph 9 of this FSP should be applied prospectively to all qualifying SPEs for unexpected events that occur after November 9, 2005.

[2] FASB Statement No. 147, except for transactions between two or more mutual enterprises, removed acquisitions of financial institutions from the scope of both FASB Statement No. 72 and FASB Interpretation No. 9.

[†] The FASB has an ongoing project to develop guidance on the accounting for combinations between two or more mutual enterprises. Currently this project is under redeliberation by FASB. Readers should monitor the FASB Website for updates on this project.

Combinations, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, are the primary source of guidance, except for combinations of two or more mutual enterprises (e.g., the combination of two credit unions). For combinations between two or more mutual enterprises, FASB Statements No. 141 and No. 142 will not be effective until interpretive guidance related to the application of the purchase method to those transactions is issued. On June 30, 2005, the FASB issued an exposure draft, *Business Combinations—a replacement of FASB Statement No. 141*. This proposed statement would apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual period beginning on or after December 15, 2006. In addition to the above-mentioned pronouncements, various EITF Issues address accounting issues related to business combinations, including EITF Topic No. D-97, *Push Down Accounting*, EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or a Business Combination*, EITF Issue No. 04-1, *Accounting for Preexisting Relationships between Parties to a Business Combination*, and EITF Issue No. 05-6, *Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination*.

19.09 In accordance with FASB Statement No. 141, business combinations should be accounted for using the purchase method. An acquiring institution shall allocate the cost of an acquired institution to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition. Prior to that allocation, the acquiring institution shall (*a*) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20–23 of FASB Statement No. 141 and (*b*) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39 of FASB Statement No. 141, regardless of whether they had been recorded in the financial statements of the acquired institution. The excess of the cost of an acquired institution over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill. An acquired intangible asset that does not meet the criteria in paragraph 39 of FASB Statement No. 141 shall be included in the amount recognized as goodwill.

19.10 For assets and liabilities acquired for which there is not an active market, determining fair values usually involves estimating cash flows and discounting those cash flows at prevailing market rates of interest. Demand deposits are valued at their face amount plus any accrued interest. FASB Statement No. 91 provides that purchases of loans or groups of loans should be recorded at their net cost, which includes the cost to the seller plus any fees paid less any fees received. The difference between this amount and the expected amounts to be received should be accounted for as an adjustment of yield over the life of the loan. SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*,[3] provides guidance as to the accounting and reporting by purchasers of certain loans for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest. Paragraph 14 of FASB Statement No. 114, as amended, provides guidance as to the determination of the effective

[3] The AICPA has recently issued a Technical Practice Aid, *Application of SOP 03-3*, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, *to Debt Securities*. For additional information visit the AICPA Web site.

interest rate when loans are acquired at a discount because of a change in credit quality or rate, or both.

19.11 FASB Statement No. 142 addresses financial accounting and reporting for intangible assets acquired individually or with a group of other assets (but not those acquired in a business combination) at acquisition. The Statement also addresses financial accounting and reporting for goodwill and other intangible assets subsequent to their acquisition. See Chapter 12 for a discussion of the requirements of FASB Statement No. 142. FASB Statement No. 141, *Business Combinations*, addresses financial accounting and reporting for goodwill and other intangible assets acquired in a business combination at acquisition. After initial recognition, goodwill and other intangible assets acquired in a business combination shall be accounted for in accordance with the provisions of FASB Statement No. 142.

FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, as Amended

19.12 FASB Statement No. 72 applies only to acquisitions between two or more mutual enterprises that are financial institutions. Paragraph 4 of FASB Statement No. 72 states that, in a business combination accounted for by the purchase method, intangible assets acquired that can be separately identified should be assigned a portion of the total cost of the acquired enterprise if the fair values of those assets can be reliably determined. The fair values of such assets that relate to depositor or borrower relationships shall be based on the estimated benefits attributable to the relationships that exist at the date of acquisition without regard to new depositors or borrowers that may replace them. Those identified intangible assets shall be amortized over the estimated lives of those existing relationships. Identified intangible assets shall be reviewed for impairment in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.[4]

19.13 Paragraph 5 of FASB Statement No. 72, as amended, states that if, in such a business combination, the fair value of liabilities assumed exceeds the fair value of tangible and identified intangible assets acquired, that excess constitutes an unidentifiable intangible asset. That asset shall be amortized to expense over a period no greater than the estimated remaining life of the long-term interest-bearing assets acquired. Amortization shall be at a constant rate when applied to the carrying amount of those interest-bearing assets that, based on their terms, are expected to be outstanding at the beginning of each subsequent period. The prepayment assumptions, if any, used to determine the fair value of the long-term interest-bearing assets acquired also shall be used in determining the amount of those assets expected to be outstanding. However, if the assets acquired in such a combination do not include a significant amount of long-term interest-bearing assets, the unidentifiable intangible asset shall be amortized over a period not exceeding the estimated average remaining

[4] The staff of the FASB issued FASB Staff Position (FSP) FAS 144-1, *Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15*, Accounting by Debtors and Creditors for Troubled Debt Restructurings, *and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets. This FSP was effective immediately. If applying this FSP results in changes to previously reported information, the cumulative effect of the accounting change should be reported as of the beginning of the first period ending after November 11, 2003. The requirements of this FSP may be applied by restating previously issued financial statements for one or more years with a cumulative-effect adjustment as of the beginning of the first year restated.

life of the existing customer (deposit) base acquired. The periodic amounts of amortization shall be determined as of the acquisition date and shall not be subsequently adjusted except as provided by paragraph 6 of FASB Statement No. 72. Notwithstanding the other provisions of paragraph 5 of FASB Statement No. 72, as amended, the period of amortization shall not exceed 40 years.

19.14 Paragraph 6 of FASB Statement No. 72, as amended, states that paragraph 14 of FASB Statement No. 142 specifies that an entity should evaluate the remaining useful life of an intangible asset that is being amortized each reporting period to determine whether events and circumstances warrant a revision to the remaining period of amortization. In no event, however, shall the useful life of the unidentifiable intangible asset described in paragraph 5 of FASB Statement No. 72, as amended, be revised upward.

Impairment and Disposal Accounting for Certain Acquired Long-Term Customer-Relationship Intangible Assets

19.15 Paragraph 6 of FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*, states that the provisions of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, apply to long-term customer-relationship intangible assets, except for servicing assets, recognized in the acquisition of a financial institution. Examples of long-term customer-relationship intangible assets include depositor- and borrower-relationship intangible assets, credit cardholder intangible assets, and servicing assets. Servicing assets, however, are tested for impairment under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.[5]

Branch Acquisitions

19.16 Depository institutions may acquire branch office locations. Such transactions typically involve the assumption of deposit liabilities by the acquiring institution in exchange for the receipt of a lesser amount of cash, or other assets, such as loans. In accordance with paragraph 5 of FASB Statement No. 147, the acquisition of all or part of a financial institution that meets the definition of a business combination shall be accounted for by the purchase method in accordance with FASB Statement No. 141.

19.17 Refer to FASB Statement No. 147, paragraph 9, to determine if the acquisition is not a business combination. If the transferred net assets and activities do not constitute a business combination,[6] that transaction shall be accounted for in accordance with paragraphs 4–8 of FASB Statement No. 141. As discussed in paragraph 9 of FASB Statement No. 142, such transactions do not give rise to goodwill.

Auditing

Objectives and Planning

19.18 The primary objective of audit procedures for business combinations is to obtain reasonable assurance that the transaction is properly accounted for

[5] See footnote 1 in paragraph 19.04.

[6] EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or a Business Combination*, provides guidance on determining whether an asset group constitutes a business.

in accordance with GAAP, particularly the provisions of FASB Statements No. 141 and No. 142, and FASB Statements No. 72, as amended, and No. 147, as applicable. Supervisory management personnel need to review and adequately support accounting entries made to record the transaction initially and those required in subsequent years including values assigned to the assets and liabilities of the acquired entity. Moreover, subsequent to the acquisition date management should review assumptions used in assigning values to assets and liabilities for continuing validity. In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements[7] as they relate to relevant assertions related to business combinations.

Substantive Tests

19.19 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to business combinations

19.20 The independent accountant should perform tests to obtain assurance regarding the fair values assigned to an acquired depository institution's or branch's assets and liabilities, which are generally supported by independent third-party appraisals. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on the independent accountant's consideration in using the work of specialists such as appraisers. The independent accountant should consider the need for asking management to engage appraisers to determine the propriety of any significant assigned carrying values that are unsupported by independent appraisals. (Chapter 11 discusses the use of real estate appraisals.)

19.21 The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist (particular attention should be focused on assumptions concerning the assessment of credit risk, loan prepayment factors, and the interest rate assigned in relation to current market conditions), (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements. The auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.

19.22 In applying procedures to a branch purchase, the independent accountant should be satisfied with the documentation supporting the fair values assigned to the deposit liabilities assumed and the assets acquired.

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[7] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of, and more guidance about the risk of material misstatement.

Chapter 20

Trust Services and Activities[*, 1]

Introduction

20.01 Among other engagements, independent accountants may be engaged to (*a*) report on trust company financial statements, particularly of common or collective trust or mutual funds, (*b*) assist with directors' examinations of trust financial information, or (*c*) report on internal control over financial reporting in the institution's trust department or (*d*) perform procedures agreed to by management or regulators or extended audit services to supplement the institution's internal audit efforts.[2,3]

20.02 Trust services and activities consist of the fiduciary services provided to customers. A fiduciary may be a trustee or an agent. Trust activities of an institution may be an integral part of the institution's services; however,

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

[1] The SEC issued Regulation B, which delineates the securities' brokerage activities in which banks may engage in without registering as a broker dealer under the Securities Exchange Act of 1934. The rule primarily affects (1) banks that handle securities brokerage transactions either as a custodian or as a fiduciary; (2) banks that have fiduciary accounts, such as trust accounts, that invest in mutual funds that pay the bank fees in conjunction with a plan authorized under the SEC's Rule 12b-1; (3) banks that offer securities through networking arrangements with registered broker-dealers; and (4) banks that enter into sweep account programs using money market funds. Banks not falling under the umbrella guidelines must register with the SEC as a broker or delineate broker activities to registered affiliates or third-party brokerage firms (www.sec.gov/rules/proposed/34-49879.htm).

[2] Usually, such an engagement is the result of the need of auditors of the financial statements of pension plans, mutual funds, and other entities to obtain audit evidence regarding internal control in the departments of a bank or savings institution controlling assets of other entities. Because an institution may administer many plans, it may not be economically feasible for each plan's independent accountant to carry out audit procedures at the trustee institution. Accordingly, one independent accountant may perform procedures in the area or department administering all plans at the institution and issue a report to the user institution on internal accounting controls related to administration of the plans. Refer to AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1). In performing an integrated audit, refer to paragraphs B18–B29 in Appendix B, of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for guidance regarding the use of service organizations. The related Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, and AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, as amended (AICPA, *Professional Standards*, vol. 1), provide guidance for such engagements. For engagements of issuers performed under PCAOB Standards, refer to AT section 501 (AICPA, *PCAOB Standards and Related Rules*).The AICPA has created a task force to revise an exposure draft titled AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. Some of the matters the task force will take into account when revising AT section 501 are (1) comments received on the original exposure draft issued on March 18, 2003; (2) PCAOB Auditing Standard No. 2; and (3) the views of insurance companies, financial institutions, related regulators, and the U.S. Government Accountability Office. On December 19, 2006 the PCAOB voted unanimously to propose for public comment a new standard for auditing internal control over financial reporting The proposed standard would replace the Board's existing internal control standard, Auditing Standard 2. Readers should be alert to any final pronouncement.

[3] Independent accountants should consider all applicable professional independence rules when providing extended audit services, such as supplementing internal audit efforts. In particular, the independent accountant should comply with the AICPA's *Code of Professional Conduct* and, if applicable, section 201 of the Sarbanes-Oxley Act of 2002 and related SEC and Public Company Accounting Oversight Board rulings.

because of strict laws[4] governing fiduciary responsibilities, institutions conduct trust activities independently through—

a. A separate department or division of the institution.

b. A separately chartered trust company.

c. A contractual arrangement with the trust department or a trust company of another depository institution.

20.03 The organizational structures of institutions' trust departments or of trust companies vary greatly depending upon factors such as the scope of trust activities, the complexity of trust services offered, management's preference, and the historical development of the entity. Trust organizations vary from small operations with one person devoted to trust activities on a part-time basis to large organizations with a variety of specialized staff such as tax attorneys, employee benefit specialists, and investment specialists.

20.04 Trusts can be broadly categorized as personal, corporate, or employee benefit.

20.05 This chapter deals primarily with how trust services and activities affect audits of the financial statements of financial institutions. However, it is important that independent accountants be fully aware of any regulatory expectations that may exist in the area of trust departments and design any engagements arising from those expectations in an appropriate manner.

20.06 Regulatory focus on the adequacy of auditing of trust operations of financial institutions has increased in recent years. The proliferation of trust charters in recent years among non-traditional bank holding companies, has led the bank and savings institution regulators to more closely assess the adequacy of secondary monitoring provided by audit functions. In cases where internal audit departments do not exist or lack the expertise required to audit the complexities of financial institutions and/or trust operations, the regulators are looking often to independent auditors to supplement the existing resources. In their respective rules on audits of fiduciary activities, the OTS (12 CFR 550.440) and OCC (12 CFR 9.9) require that management arrange for a suitable audit of trust operations through the efforts of external and/or internal auditors on an annual basis or as part of a continuous audit process.

20.07 While this is an important opportunity for independent accountants, it is one which must be carefully dealt with from a standpoint of managing expectations and attentiveness to audit and attestation standards. First, the audit requirements of the OTS and OCC are largely related to operating and compliance controls which are likely not tested in the audit of financial statements of a financial institution. Also the depth of testing of financial reporting controls will likely be greater than in a financial statement audit. Accordingly, the testing required in these areas should be the subject of separate engagements under standards for attestation engagements or consulting standards as they relate to extended audit services.

[4] Most notably, Title 12 of the Code of Federal Regulations (12 CFR), Parts 9 (OCC) and 550 (OTS); state fiduciary laws often provide additional requirements.

Personal Trusts

20.08 Personal trust accounts may be established for individuals or other entities such as foundations, college endowments, and not-for-profit organizations. A brief description of the primary kinds of personal trusts follows.

a. *Testamentary trusts* are created under a will. Administrative responsibility begins when assets are transferred from the estate to the trust. Almost all testamentary trusts are irrevocable.

b. *Voluntary trusts* (*inter vivos*), also referred to as *living trusts*, are established by individuals during their lifetimes. This type of trust is often established with powers of revocation or amendment. Furthermore, it has been increasingly common for the grantor of the trust to retain the power to control or participate in deciding on investments resulting in a self-directed trust.

c. *Court trusts* are trusts in which the trustee is accountable to a court. Court trusts generally include decedents' estates (under which the courts appoint administrator institutions to settle the estates of persons who either died without leaving wills or who nominated the institutions as executors in their wills), guardianships, and some testamentary trusts.

d. *Agency agreements* provide for the care of other parties' securities and properties. Safekeeping and custodianship agreements are two of the more common types.

e. *Property management agreements* provide for the management of property, for example, real estate or securities investments, by the trustee institution. The institution, as agent, has managerial duties and responsibilities appropriate to the kind of property being managed. (Such agreements also may exist for employee benefit trusts.)

20.09 Closely held business management responsibilities may arise through the normal course of events when an institution serves as trustee of a personal trust (or employee benefit trust) that holds ownership of the enterprise, through involvement in winding down the affairs of an estate, or through a specialized property management agreement.

Corporate Trusts

20.10 A brief description of the primary kinds of corporate trust activities follows.

a. As *transfer agent*, the trust department or trust company transfers registered (in contrast to bearer) securities from one owner to another and maintains the records of ownership.

b. As *registrar*, the trust department or trust company maintains for corporations control over the number of shares issued and outstanding.

c. As *joint registrar-transfer agent*, the trust department or trust company acts jointly as registrar and transfer agent for the same issue.

d. As *paying agent*, the trust department or trust company distributes interest or dividend payments or redeems bonds and bond coupons of corporations and political subdivisions within the terms of an agency agreement.

e. When an institution is a *trustee under indenture*, the trust department or trust company acts as an agent designated by a municipality, corporation, or other entity to administer specified cash receipt or payment functions. The trust department or trust company performs the duties specified in the agreement, which might include holding collateral; issuing bond instruments; maintaining required records, accounts and documentation; monitoring for default; ensuring legal compliance; and effecting the payment of principal and interest.

Employee Benefit Trusts

20.11 In recent years, the employee benefit trust has become a common arrangement to handle the investment of assets of employee benefit plans and the disbursement of plan assets for payments of benefits to participants. Usually employee benefit trusts are utilized in connection with employee benefit plans governed by the Employee Retirement Income Security Act of 1974 (ERISA), the federal law dealing with employee benefit plans. A brief description of the primary kinds of employee benefit trusts follows.

a. *Pension or profit-sharing trusts* provide for a trustee institution to manage trust funds established for the benefit of eligible company officers or employees or for members of a union, professional organization, or association. Such trusts are established by comprehensive written plans in which the trustees' powers are limited and their duties are well defined. These trusts may exist in connection with a variety of types of benefit plans, including defined benefit plans, defined contribution plans, individual retirement accounts (IRAs), and health and welfare plans.

b. *Master trusts* are special trust devices used to bring together various employee benefit trusts of a plan sponsor for ease of administration. For instance, an employer may have similar benefit plans for different subsidiaries, divisions, or classes of employees. Rather than maintain separate employee benefit trusts for each plan, all of the plans, subject to restrictions of ERISA, may pool the trust assets in a single master trust and maintain separate subaccounts for each plan to preserve accountability. A master trust may also be structured to establish separate pools of trust assets managed by different investment advisers selected by the plan sponsor.

Common or Collective Trust Funds

20.12 Common or collective trust funds are arrangements in which the funds of individual trusts (that is, personal or employee benefit trusts) are pooled to achieve greater diversification of investment, stability of income, or other investment objectives. Under OCC regulations at 12 C.F.R. Part 9 there are: (*a*) common trust funds,[5] which are maintained exclusively for the collective investment of accounts for which the institution serves as trustee, executor, administrator, conservator, and guardian, and (*b*) collective trust funds or

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[5] Common trust funds are exempt from federal income taxes under Section 584 of the Internal Revenue Code. Collective investment funds are exempt from federal income taxes under IRS Revenue Ruling 81-100.

commingled pension trust funds, which consist solely of assets of retirement, pension, profit-sharing, stock bonus, or other trusts that are exempt from federal income taxes.

Regulatory Matters

20.13 Some institutions are also involved with mutual funds. Their involvement may range from corporate trust activities, which are generally administrative in nature, to investment advisory activities, or may simply involve custodial activities. Some institutions sell funds sponsored by an independent fund group. Others may use their name on a fund sponsored by a third party.

20.14 12 CFR Part 9 sets forth rules concerning a national bank's operation of collective investment trusts. The independent accountant may be engaged to perform certain agreed-upon procedures required by the Office of the Comptroller of the Currency (OCC) relative to all other trust activities. The OTS has similar requirements. Regulatory approval is generally required before institutions enter into operations involving mutual funds.

20.15 The federal banking agencies use the Uniform Interagency Trust Rating System (UITRS) as a tool to evaluate the soundness of fiduciary activities of financial institutions on a uniform basis and to identify those institutions requiring special supervisory attention. The UITRS was revised in 1998 to place more emphasis on risk management and more closely align the ratings definitions language and tone with those of the CAMELS ratings definitions.

Accounting and Financial Reporting

20.16 While a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements. However, cash accounts of individual trusts are often deposited with the institution in demand and time deposit accounts, and revenues and expenses related to fees for trust activities are recognized in the institution's income. Trust department income should be presented on the accrual basis. Financial institutions often make financial statement disclosures describing the nature of the trust activities and are required to apply the provisions of Financial Accounting Standards Board (FASB) Statement on Financial Accounting Standards No. 5, *Accounting for Contingencies*, to any contingencies that may exist related to trust activities.

Auditing

Objectives

20.17 The primary objectives of financial statement audit procedures applied in the trust operations area are to obtain reasonable assurance that—

a. The institution has properly described and disclosed in the financial statements contingent liabilities associated with trust activities.

b. Fee income resulting from trust activities is recognized properly in the institution's financial statements.

Planning

20.18 In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the independent accountant should obtain audit evidence about the factors influencing the risks of material misstatements,[6] which are described in Chapter 5, "Audit Considerations and Certain Financial Reporting Matters," as they relate to the relevant assertions related to trust activities. Such factors may include:

a. The organization of the trust department and the degree of separation from the commercial banking departments (for example, the role of legal counsel in trust account administration and the vulnerability to disclosure of insider information)

b. The nature of comments on trust operations indicated in supervisory agency or internal audit reports

c. The extent and nature of insurance coverage

d. The type and frequency of lawsuits, if any, brought against the institution and arising from trust operations

e. The nature, complexity, and reliability of data-processing systems

f. The nature and extent of lending of securities from trust accounts

The significance of an institution's exposure to liability (including liability related to the reporting of tax information) is a function of (*a*) the relative significance of the trust assets administered, (*b*) whether the institution has discretionary investment authority, (*c*) the complexity of transactions entered into by the trust, (*d*) the number of trusts administered, and (*e*) the effectiveness of administration of the trust. Thus, the importance of the trust department in an audit of an institution's financial statements should not be underestimated.

Internal Control Over Financial Reporting and Possible Tests of Controls in a Financial Statement Audit[7]

20.19 AU section 314 (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the independent accountant's consideration of an institution's internal control in an audit of financial statements. It describes the components of internal control and explains how an independent accountant should obtain a sufficient understanding of internal controls for the purposes of assessing the risks of material misstatements. Paragraph .40 of AU section 314, requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to (1) evaluate the design of internal controls and (2) determine whether they are implemented. A sufficient understanding is obtained by performing risk assessment procedures. The auditor is also required to assess the risks of material misstatement at both the overall financial statement level and at the assertion level.

20.20 In addition to the above, when performing an integrated audit of financial statements and internal control over financial reporting, in accordance

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[6] See paragraph .22 of AU section 312, *Audit Risk and Materiality in Conducting and Audit* (AICPA, *Professional Standards*, vol. 1), for the definition of and more guidance about the risk of material misstatement.

[7] See footnote 1 in Chapter 5 regarding the applicability of PCAOB standards.

with PCAOB Standards, refer to Auditing Standard No. 2, paragraphs 104–105 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") for a discussion on the extent of test of controls.[8] For purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit.

20.21 Accounting systems for trust departments generally use sophisticated electronic data-processing systems. The accounting records of a trust department generally should reflect the department's asset holdings and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. Records providing detailed information for each trust account generally should include the following:

- Principal (corpus) control account
- Principal cash account
- Income cash account
- Investment records for each asset owned, such as stocks, bonds, notes and mortgages, savings and time accounts, real property, and sundry assets
- Liability record for each principal trust liability
- Investment income

20.22 The independent accountant may need to evaluate trust departments' and trust companies' overall internal control over financial reporting, including the following controls.

- Individual account and departmental transactions (activity control) and suspense items are reconciled and recorded in a complete, accurate, and timely manner.
- Written policies, procedures, and controls exist for securities lending activities, including review of the borrower's creditworthiness, a formal lending agreement, and minimum collateral requirements.
- Periodic reconciliations of the trust funds on deposit with the institution or its custodian are performed by an employee having no check-signing authority or access to unissued checks and related records.
- Measures have been taken to safeguard trust assets by dual control.
- Accurate files of documents creating trusts and authorizing transactions are maintained.
- Vault deposits and withdrawals are reconciled with accounting records to promptly reflect the purchase and sale of trust assets.
- Reconciliation of agency accounts (for example, dividends, coupons, and bond redemptions) are performed regularly by an employee having no access to unissued checks or participation in the disbursement function.

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[8] Auditing Standard No. 2, paragraph 218 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), provides further guidance.

- Periodic physical inspection of assets or confirmation of trust assets is conducted by an independent person.
- There is frequent reporting and written approval of uninvested cash balances and overdrafts.
- Procedures exist to ensure compliance with income and other tax filing and remittance requirements.
- Reviews are conducted to make sure all duties required by the governing trust instruments or agency contracts (legal compliance) are performed.

Financial Reporting Controls of the Trust

20.23 Additional controls that the independent accountant may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams, engagements under AU section 324 (AICPA, *Professional Standards*, vol. 1), and agreed upon procedures or other extended audit services) include the following.

- Authorization and review procedures are in place to ensure that assets accepted into a trust conform with provisions of the trust and applicable laws and regulations.
- The physical and administrative security (physical control) of assets for which the trust department has responsibility is segregated from transaction authorization and recordkeeping.
- Trust assets are segregated from the institution's assets and are periodically inspected by people outside the trust department or trust company.
- Trust assets are registered in the name of the institution as fiduciary or in the name of the nominee.
- Proper approval is obtained from cofiduciaries (or investment power holders in self-directed trusts) for investment changes, disbursements, and so forth.
- Approval of the individual purchase and sale of all trust investments is performed by the trust or investment committee or its designees. It is important that for assets where the trustee has discretionary (investment powers) authority, investment restrictions imposed by the client are being adhered to. The independent accountant should also obtain an understanding of computer models that may be used to assist in making investment decisions or to determine whether the investment objectives of the funds are being met.
- Procedures exist to ensure proper classification of trust assets, both by trust title and by nature of asset, daily posting of journals containing detailed descriptions of principal and income transactions, and establishment of control accounts for various asset classifications, including principal and income cash.
- Procedures exist to safeguard unissued supplies of stocks and bonds by dual control.
- Periodic mailings are made of account statements of activity to an external party designated by the client.

- Policies and procedures exist related to identification and resolution of failed trades and the contractual settlement of trades posted to trust accounts.
- Complete legal files are maintained.
- Based on the nature of trust contracts, accurate tax reporting is performed.

Substantive Tests Related to Financial Statement Audits

20.24 ***Testing of Trust Department Revenues and Expenses.*** Although a substantial amount of activity may be conducted and reported on within the trust department, items typically reflected in the institution's financial statements are income from trust or agency services and trust operation expenses. Those areas may be tested independently or may be integrated, as appropriate, with other tests of trust operations.

20.25 ***Contingent Liabilities.*** The independent accountant should design audit procedures to determine whether any contingent liabilities should be recognized or disclosed in the institution's financial statements. Acceptance of certain assets, such as real estate with environmental contamination that subjects the trustee to environmental liabilities and ineligible investments in employee benefit trusts subject to ERISA, may result in substantial liabilities for both the trust and trustee. If the institution is providing guarantees to beneficiaries or others associated with the trusts, procedures may need to be performed to determine if the institution has complied with the requirements of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*[9] or FASB Statement No. 133, as amended, if the guarantee meets the definition of a derivative. Further, the independent accountant should consider determining the extent to which an institution has engaged in off-balance-sheet activities that create commitments or contingencies, including innovative transactions involving securities and loans (such as transfers with recourse or put options), that could affect the financial statements, including disclosures in the notes. Inquiries of management relating to such activities should be formalized in the representation letter normally obtained at year-end. The independent accountant should also consider reviewing the institution's documentation to determine whether particular transactions are sales or financing arrangements.

20.26 In February of 2006 the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*. This Statement shall be effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of this Statement may also be applied upon adoption of this Statement for hybrid financial instruments that had been

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[9] In addition to FASB Interpretation No. 45, the FASB staff issued two FASB Staff Positions (FSP) FIN 45-2, *Whether FASB Interpretation No. 45*, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, *Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value* that was effective immediately, and FSP FIN 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a business or Its Owners*. FSP FIN 45-3 should be applied for new minimum revenue guarantees issued or modified on or after the beginning of the first fiscal quarter following November 10, 2005.

bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of this Statement.

20.27 In March of 2006 the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140.* FASB Statement No. 156 amended paragraphs 21 and 56 of FASB Statement No. 133. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

Substantive Procedures Related to the Trust

20.28 Additional substantive procedures that the independent accountant may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams, engagements under AU section 324 (AICPA, *Professional Standards*, vol. 1), and agreed upon procedures or other extended audit services) follow.

20.29 Examination of a trust department's activity includes tests of systems and procedures that are common to the management of all or most individual trusts or agency accounts and tests of the activity in selected representative individual trust accounts in each area of trust department service (for example, personal, corporate, and employee benefit).

20.30 ***Testing of Trust Activities' Common Procedures.*** The procedures followed for the numerous types of trusts and agency activities involve many common or similar functions. Tests of the department's conduct of those activities may be on the department as a whole rather than on individual trusts. Functions that may be tested by the department include the following:

- Opening of new accounts
- Receipt and processing of the initial assets that constitute an account
- Processing of purchases, sales, and exchanges of principal assets
- Receipt and payment of cash or other assets
- Collateralization of trust assets held in deposit accounts at the institution, affiliate, or outside custodian, where required
- Execution of specified trust or agency activities
- Determination of fees and charging of fees to accounts
- Processing of trust assets in and out of the trust vault
- Closing of accounts

20.31 ***Testing of Account Activity.*** The independent accountant should perform detailed tests to obtain reasonable assurance that transactions and activities within the various types of trust accounts are being conducted properly. The tests may cover asset validation, asset valuation, and account administration. For asset validation, a sample of accounts may be selected, trial balances of assets obtained, and the physical existence of assets for which the trust is responsible determined on a test basis. For account administration, a sample of trust accounts may be selected for testing of individual transactions. If appropriate, certain of those transactions may be incorporated in testing of common procedures in the trust department. The independent accountant may coordinate the selection of accounts for testing asset validation and account administration. The independent accountant should consider performing the following procedures for the selected accounts:

a. Read the governing instrument and note the significant provisions.

b. Review activity during the period being audited for compliance with the governing trust instrument and applicable laws and regulations.

c. Review the assets held for compliance with the provisions of the governing trust instrument.

d. Examine brokers' advices or other documentary evidence supporting the purchase and sale of investments.

e. For real estate accepted or acquired, determine that appropriate measures are taken to identify potential environmental liability and to properly document the evaluation.

f. Ascertain that real estate holdings are insured and are inspected on a periodic basis and that appraisals are performed or otherwise obtained as required by the governing trust instrument and applicable laws and regulations.

g. Obtain reasonable assurance that income from trust assets has been received and credited to the account.

h. Obtain reasonable assurance that required payments have been made.

i. Test computation and collection of fees.

j. Determine whether the account has been reviewed by the investment committee as required by the supervisory authorities or by local regulations.

k. Test the amounts of uninvested cash to determine whether amounts maintained and time held are not unreasonable.

l. Review any overdrafts and obtain reasonable assurance that they have a valid business purpose and are covered by appropriate borrowings to avoid violations of laws and regulations.

m. Independently test market values used in valuing investments.

n. Review the "soft dollar" charges allocated to funds for appropriateness.

o. Determine whether required tax returns have been filed.

p. Review the adequacy of trust reporting of co-trustees and beneficiaries.

q. Confirm individual trust account assets, liabilities, and activity with co-trustees and beneficiaries.

r. Test valuation procedures.

Audits of Unit Investment Trusts

20.32 The AICPA Audit and Accounting Guide *Investment Companies,*[†] provides guidance on the auditing of financial statements of investment companies and unit investment trusts.

[†] In April of 2006 the Auditing Standards Board (ASB) issued SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*, which was effective on issuance. This SOP supersedes SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Standards*, along with specific paragraphs contained in the AICPA Audit and Accounting Guide on *Investment Companies*.

Chapter 21

Insurance Activities[*]

Introduction

21.01 Insurance operations ordinarily are an integral part of consumer finance activities. This chapter deals primarily with insurance business generated from finance customers, though it also addresses insurance coverage provided to others who are not also finance customers.

Types of Insurance Coverage

21.02 Insurance activities of finance companies often involve insuring risks related to loan transactions. Following are the three general types of insurance coverage associated with those transactions:

a. Credit life coverage for loan repayment in the event of the debtor's death

b. Credit accident and health coverage for installment loan payments in the event of the debtor's illness or disability for an extended period

c. Property and liability coverage on collateral or other property associated with the loan transaction

Credit Life

21.03 Credit life insurance is a form of term insurance that provides for loan repayment if the debtor dies before the loan is fully paid. It ordinarily is written on a single-premium basis, with the amount of the premium added to the loan balance and paid as part of the scheduled installments on the loan.

21.04 Credit life insurance includes level term insurance and decreasing term insurance. *Level term insurance* provides a fixed amount of coverage, generally the original amount of the loan. *Decreasing term insurance*, the more common type, insures the debtor's life to the extent of the unpaid balance of the loan, sometimes less any delinquent payments, at the date of death. However, decreasing term insurance usually is based on the contractual loan period. Therefore, the insurer may not pay off the entire uncollected balance on the loan if it is in delinquency status at the time of the debtor's death. The extent to which delinquent installments are covered generally depends on the insurance contract and on applicable state insurance rules and regulations.

21.05 The insurer's risk exposure on a policy at a given point in time under level term insurance differs from that under decreasing term credit life insurance. Because level term insurance provides coverage equal to the original amount of the loan, the insurer's risk exposure is constant throughout the term of the loan. In contrast, the insurer's exposure under decreasing term insurance decreases as scheduled loan repayments become due, usually in direct proportion to the regular monthly reductions of the loan balance.

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and non-issuers (see definitions in the Preface).

Credit Accident and Health

21.06 Credit accident and health insurance requires the insurer to make the debtor's monthly loan payments during extended periods of illness or disability. Ordinarily it is written on a single-premium basis, with the premium added to the loan amount and, hence, paid as part of the periodic installments. Under an accident and health policy, the insurer's total risk exposure decreases—as in a decreasing term credit life insurance policy—as loan repayments are made. However, the size of potential claims and the related risk exposure do not decrease in direct proportion to the reduction in the unpaid loan balance, because most credit accident and health insurance claims are for short-duration disabilities that are cured in a period shorter than the remaining loan term.

Property and Liability

21.07 Ordinarily, a finance company requires that the collateral pledged as security to a loan be protected by property insurance. Such coverage may be obtained from the lender's insurance subsidiary or from an unaffiliated insurer. The amount of coverage is usually based on the value of the collateral and does not necessarily bear a relationship to the unpaid balance of the loan. Property insurance policies issued in connection with finance transactions can be written either on a single-premium basis for the loan term or for an annual or other period of less than the remaining loan term, and the policy renewed as required. Premiums charged by lenders' insurance affiliates for property insurance coverage related to finance transactions frequently are added to the loan amount and paid as part of the regular installment payments on the loan.

Writing Policies

21.08 An insurance subsidiary of a finance company may be a direct writing or a reinsurance company. A direct writing company writes the insurance policies in its name. A reinsurance company insures policies written by direct writing companies.

21.09 The insurance can be issued on either a group or an individual policy basis. For group coverage, the insurer issues the policy to the finance company, which in turn issues individual certificates to its debtor-customers. Group policies may be subject to experience-rated premium adjustments based on experience and profitability of the group being covered.

Commissions

21.10 Insurers, both insurance subsidiaries and independent companies, may pay commissions to companies. Those payments may be in the form of advance commissions computed as a percentage of premiums, retrospective or experience-rated commissions, or combinations of advance commissions and retrospective commissions.

Regulatory Matters

21.11 Credit unions may offer through a credit union service organization (CUSO), the following insurance brokerage or agency services:

1. Agency for sale of insurances;

2. Provision of vehicle warranty programs; and
3. Provision of group purchasing programs.

Other activities or services that CUSOs may provide are outlined in Part 712 of the National Credit Union Administration Rules and Regulations.

Accounting

21.12 The following lists the primary source of accounting guidance for enterprises that issue insurance contracts: FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; FASB Statement No. 97,[1] *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*; FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*; FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*; Securities and Exchange Commission Regulation S-X, Article 7; SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as amended; SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*; SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*; SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*; SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*; and SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*, and SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*. Additionally, the AICPA Audit and Accounting Guides *Life and Health Insurance Entities* and *Property and Liability Insurance Companies*, contains a complete listings of all insurance specific literature.

Premium Income

21.13 Premium income should be recognized in accordance with the methods described in FASB Statement No. 60, as amended. The statement classifies insurance contracts as being of short or long duration, depending on the period over which such contracts are expected to remain in force. The statement provides the following guidance on factors to consider in determining whether a contract is of short or long duration:

a. Short-duration contracts provide insurance protection for a fixed period of short duration and enable insurers to cancel the contracts or to adjust provisions of the contracts (such as the amount of premiums charged or coverage provided) at the end of any contract period.

b. Long-duration contracts generally are not subject to unilateral changes in their provisions, such as noncancelable or guaranteed renewable contracts, and require performance of various functions and services (including insurance protection) for extended periods.

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[1] The FASB staff issued FASB Staff Position (FSP) FAS 97-1, *Situations in Which Paragraphs 17(b) and 20 of FASB Statement No. 97*, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, Permit or Require Accrual of an Unearned Revenue Liability.

21.14 FASB Statement No. 60, as amended, indicates that examples of short duration policies include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. The statement also indicates that accident and health insurance contracts may be of short duration or long duration, depending on the terms of such contracts.

21.15 Insurance policies issued in connection with consumer lending generally are considered to represent short-duration contracts. Premiums from such contracts are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. According to paragraph 13 of FASB Statement No. 60, "That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule."

Policy Acquisition Costs

21.16 Policy acquisition costs are defined in FASB Statement No. 60 to be costs that both vary with and are primarily related to the acquisition of insurance contracts. Policy acquisition costs should be deferred and amortized to income over the terms of the policies by the same method used to account for insurance premium income. Commissions paid to the affiliated companies and premium taxes normally are the most significant elements of acquisition costs for captive insurance companies. Deferred costs associated with payment of such commissions and other intercompany items should be eliminated in consolidation.

21.17 The AICPA issued SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*. The SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FASB Statement No. 97. The SOP is effective for internal replacements occurring in fiscal years after December 15, 2006. The AICPA also issued a series of Technical Practice Aids (TPAs) on accounting and financial reporting issues related to SOP 05-1 (section 6300.25 through 6300.35). SOP 05-1 applies to all entities to which FASB Statement No. 60, applies, and is applicable to modifications and replacements made to contracts defined by FASB Statement No. 60 as short-duration and long-duration contracts, including those contracts defined by FASB Statement No. 97 as investment contracts.

21.18 Readers should be aware that in applying the guidance in SOP 05-1, paragraph 8 of SOP 05-1 defines an internal replacement is a modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange), or by amendment, endorsement, or rider to a contract, or by the election of a benefit, feature, right, or coverage within a contract.

Investment Portfolios

21.19 Insurance subsidiaries maintain investment portfolios usually composed of the same types of securities found in the portfolios of independent insurance companies. State regulations restrict the types of investments that insurance companies may make.

21.20 FASB Statement No. 115 amends FASB Statement No. 60 to require that insurance enterprises account for all investments in debt securities and investments in equity securities that have readily determinable fair values, as defined by FASB Statement No. 115[2,†] in accordance with the provisions of FASB Statement No. 115.

21.21 SOP 01-6, paragraph 13*h*, states that, insurance subsidiaries may be required to deposit securities with state regulatory authorities. If so, the carrying amount of securities deposited should be disclosed.

State Laws

21.22 Insurance companies are regulated by state insurance laws, which require maintenance of accounting records and adoption of accounting practices. The insurance laws and regulations of the states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as otherwise prescribed or permitted by state law. Some prescribed or permitted statutory accounting practices differ from generally accepted accounting principles. Accordingly, the financial statements of insurance subsidiaries prepared for submission to regulatory authorities must be adjusted to conform to generally accepted accounting principles before they can be consolidated with the financial statements of the parent companies.

Commissions

21.23 A finance company may receive commissions from an independent insurer for policies issued to finance customers. Insurance commissions received from an independent insurer should be deferred and systematically amortized to income over the life of the related insurance contracts because the insurance and lending activities are integral parts of the same transactions. The method of commission amortization should be consistent with the method of premium income recognition for that type of policy as set forth in FASB Statement No. 60.

21.24 SOP 01-6, paragraph 9, states that, income from experience-rated or retrospective commission arrangements should be recognized over the applicable insurance risk period.

21.25 Commissions paid to its parent company by an insurance subsidiary are eliminated in consolidation.

Consolidation Policy

21.26 Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires consolidation of all majority-owned subsidiaries unless control does not rest with the majority owner. FASB Statement

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[2] The FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The guidance in this FSP should be applied to reporting period beginning after December 15, 2005.

[†] The FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The effective date is November 15, 2007. Entities may opt for early adoption of Statement No. 159, subject to conditions outlined in the Statement.

No. 94 requires consolidation of a majority-owned subsidiary even if it has *nonhomogeneous* operations, a large minority interest, or a foreign location. FASB Statement No. 94 also precludes use of parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity. The statement requires that summarized information about the assets, liabilities, and results of operations (or separate statements) of previously unconsolidated majority-owned subsidiaries continue to be provided after those subsidiaries are consolidated. Furthermore, to address consolidation by business entities with certain characteristics, FASB Interpretation No. 46,[3,4,5] *Consolidation of Variable Interest Entities* (revised December

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[3] Application of FIN No. 46(R) is required for public entities that have interests in entities commonly referred to as variable interest entities. Application by small business issuers to *variable interest entities* other than *special-purpose entities* and by nonpublic entities to all types of *variable interest entities* was required at various dates in 2004 and 2005.

[4] The FASB has issued the following FASB Staff Positions (FSP) associated with the issuance of FIN No. 46(R):

1. FSP FIN 46(R)-1, "Reporting Variable Interests in Specified Assets of Variable Interest Entities as Separate Variable Interest Entities under Paragraph 13 of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
2. FSP FIN 46(R)-2, "Calculation of Expected Losses under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
3. FSP FIN 46(R)-3, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*."
4. FSP FIN 46(R)-4, "Technical Correction of FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, Relating to Its Effects on Question No. 12 of EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities.""

The above FSPs, FIN 46(R), FIN 46(R)-1, FIN 46(R)-2, and FIN 46(R)-3 replaced FIN 46-2, FIN 46-5, and FIN 46-8, respectively, with the effective dates and transition provisions applied accordingly.

5. FSP FIN 46(R)-5, "Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*" (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and previously unrelated parties.) For entities to which Interpretation 46(R) had been applied, the guidance in this FSP was applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) was permitted but not required. Early application was permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP was applied in accordance with the effective date and transition provisions of Interpretation 46(R).
6. FSP FIN 46-8, "Evaluating Whether as a Group the Holders of the Equity Investment at Risk Lack the Direct or Indirect Ability to Make Decisions about an Entity's Activities through Voting Rights or Similar Rights under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*." Effective for all arrangements to which FIN 46 had been applied. If the application of this FSP resulted in changes to previously reported information, the cumulative effect of the accounting change would have been reported as of the beginning of the quarter that includes December 19, 2003 (the quarter beginning October 1, 2003, for a calendar-year entity).
7. FSP FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No.46(R)" An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective

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2003) (FIN No. 46(R)), clarified the application of ARB No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. Insurance subsidiaries of financial institutions may participate in variable interest entities through investing in structured investments, such as asset-backed securities, synthetic asset-backed securities and catastrophe bonds, certain structured reinsurance transactions, joint ventures without substantive operations, financial guarantees, debt issuance vehicles, synthetic leases, collateralized bond obligation issuances, or limited partnerships. In addition, separate accounts of life insurance entities as described in the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*, are not subject to consolidation according to the requirements of FIN No. 46(R).

Financial Statement Presentation

21.27 SOP 01-6, paragraph 14*j*, states that, unearned premiums and unpaid claims on certain insurance coverage issued to finance customers by a subsidiary may represent intercompany items because premiums are added to the consumer loan account, which is in turn classified as a receivable until paid, and most or all of the payments on claims are applied to reduce the related finance receivables. Therefore, unearned premiums and unpaid claims on certain credit life and credit accident and health insurance policies issued to finance customers should be deducted from finance receivables in the consolidated balance sheet. The following illustrates that type of presentation:

Finance receivables	XXX
Less:	
Allowance for losses	(XXX)
Unearned premiums and unpaid claim liabilities related to finance receivables	(XXX)
Finance receivables, net	XXX

Alternatively, the balance sheet may present only the net finance receivables if the notes to the financial statements contain sufficient disclosure of unearned premiums and unpaid claims and the allowance for losses. Unearned premiums and unpaid claims for credit life and accident and health coverage should not be applied in consolidation against related finance receivables for which the related receivables are assets of unrelated entities.

21.28 SOP 01-6, paragraph 14*k*, stated that, in the consolidated financial statements, unpaid claims for property insurance and level term life insurance, however, should not be offset against related finance receivables because finance companies generally do not receive substantially all proceeds of such claims.

(footnote continued)

application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

[5] For additional assistance, refer to the AICPA's Technical Practice Aid (TPA) 1400.29, "Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* (www.aicpa.org/download/acctstd/FIN_46_R_TPAs.pdf).

That prohibition also applies to credit life and accident and health coverage written on policies for which the related receivables are assets of unrelated entities. In those circumstances, such amounts should be presented as liabilities.

21.29 FASB Statement No. 131, *Disclosures about Segments of a Business Enterprise and Related Information*,[6] requires public companies to present in their financial statements information about reportable operating segments. In addition, SOP 94-5 and other accounting pronouncements referenced above require disclosures related to insurance activities.

Auditing

21.30 The AICPA Audit and Accounting Guide *Life and Health Insurance Entities,* and the Audit and Accounting Guide *Property and Liability Insurance Companies,* provide guidance on auditing concepts and procedures for insurance companies. The auditor should consider reviewing these AICPA guides for information. In addition, the auditor should consider whether accounts between the finance company and the insurance subsidiaries are reconciled regularly.

21.31 Because the premiums and commissions associated with insurance provided to finance customers ordinarily are an integral part of the related finance and loan transactions, the audit procedures used to test and evaluate finance transactions should include related insurance activities. Similarly, branch office controls over loans usually apply to insurance products. The auditor should be satisfied that the income recognition methods for insurance premiums and commission income conform to the principles discussed in this chapter.

21.32 ***Audits performed in accordance with PCAOB standards***. Auditors should refer to Auditing Interpretation No. 4 in AU section 9326.28–.41, "Applying Auditing Procedures to Segment Disclosures in Financial Statements" (AICPA, *Professional Standards*, vol. 1), for guidance on auditing segment disclosures.

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[6] The FASB issued EITF Issue No. 04-10, *Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds*, to provide additional guidance in determining the aggregating of operating segments.

Chapter 22

Reporting Considerations[*]

Introduction

22.01 This chapter applies the guidance found in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), and related PCAOB requirements when performing integrated audits, to audit reports on the financial statements of financial institutions. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, an adverse opinion, or a disclaimer of opinion. This chapter contains a brief discussion of each of those reports, with an emphasis on illustrating issues that an independent accountant may encounter in the industry. The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report. Paragraphs 22.20–22.25 apply only to credit unions.

Reports

Unqualified Opinion

22.02 The independent accountant's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the country of domicile (GAAP). This conclusion may be expressed only when the independent accountant has formed such an opinion on the basis of an audit performed in accordance with auditing standards generally accepted in the country of domicile (GAAS). The following is an illustration of an independent accountant's standard report (unqualified opinion) on the financial statements of a bank or savings institution.

> To the [*Institution, Board of Directors, or Stockholders*]:
>
> We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X5 and 20X4, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[1] Those standards

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[*] Refer to the Preface of this Guide for important information about the applicability of the professional standards related to audits of issuers and non-issuers (see definitions in the Preface).

[1] For audits conducted in accordance with PCAOB Standards, PCAOB Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, replaces this sentence with the following sentence, "We conducted our audits in accordance with the standards of the Public Company Oversight Board (United States)." On May 14, 2004, the SEC issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 24, 2004, references in SEC rules and staff guidance and in federal securities laws to GAAS or to specific standards under

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require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X5 and 20X4, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

22.03 Refer to AU section 508 (AICPA, *Professional Standards*, vol. 1) when performing an integrated audit of financial statements and internal control over financial reporting. The auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to Auditing Standard No. 2, paragraphs 162–199 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), for direction on reporting on internal control over financial reporting. In addition, see Appendix A, in Auditing Standard No. 2, paragraph 217 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"),

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(footnote continued)

GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The staff of the PCAOB published a series of questions and answers ("Q&As") on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

In June 2004, the Auditing Standards Board ("ASB") issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of SAS No. 58, *Reports on Audited Financial Statements*, which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB Auditing Standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB Auditing Standards. The ASB also has undertaken a project to determine what amendments, if any, should be made to SAS No. 58. See the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ for more information.

[2] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of SAS No. 58, which was issued by the ASB in June 2004 and provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> "An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

which includes an illustrative combined audit report and examples of separate reports.

22.04 If the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements. See AU section 508.08 (AICPA, *Professional Standards*, vol. 1):

> "We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*]."

22.05 When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the Standards of the PCAOB, the auditor's report on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to AU section 530.01 (AICPA, *Professional Standards*, vol. 1) for direction about the report date in an audit of internal control over financial reporting.

Explanatory Language Added to the Auditor's Standard Report

22.06 Certain circumstances, while not affecting the independent accountant's unqualified opinion, may require that the independent accountant add an explanatory paragraph (or other explanatory language) to the standard report. A number of such circumstances are listed in paragraph .11 of AU section 508. This section addresses one of them, namely, the existence of substantial doubt about an institution's ability to continue as a going concern.

22.07 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), as amended, describes the independent accountant's responsibility for evaluating whether there is substantial doubt about the ability of the entity whose financial statements are being audited to continue as a going concern for a reasonable period of time. Chapter 17 describes going-concern considerations as they relate to banks and savings institutions and discusses how an institution's regulatory capital position should be considered in the independent accountant's assessment of whether there is substantial doubt about the institution's ability to continue as a going concern. If the independent accountant concludes that there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph) to express that conclusion. The independent accountant's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its [the entity's] ability to continue as a going concern" or similar wording that includes the terms *substantial doubt* and *going concern*.[3] The following is an illustration of an independent accountant's report on the financial statements of a bank or savings institution that includes an explanatory

[3] Footnote 5 to AU section 341.13, "Consideration of the Effects on the Auditor's Report" (AICPA, *Professional Standards*, vol. 1), says, in part:

> In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

paragraph because of the existence of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time.

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X5 and 20X4, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[4] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X5 and 20X4, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 20X5, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 20X7. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital plan. Failure to meet the capital requirements and interim capital targets included in the capital plan would expose the Institution to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

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[4] See footnote 1.

22.08 AU section 341 states that the inclusion of an explanatory paragraph (following the opinion paragraph) in the independent accountant's report as described above serves adequately to inform users of the financial statements of the independent accountant's substantial doubt. Nevertheless, AU section 341 does not preclude the independent accountant from declining to express an opinion in cases involving uncertainties. If the independent accountant disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the independent accountant's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an independent accountant's disclaimer of opinion because of the existence of substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time.

> To the [*Institution, Board of Directors, or Stockholders*]:
>
> We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X5 and 20X4, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to report on these financial statements based on our audits.
>
> We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[5] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our report.[6]
>
> The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 20X5, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital restoration plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 20X7. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital restoration plan. Failure to meet the capital requirements and interim capital targets included in the Institution's capital plan would expose the bank to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's

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[5] See footnote 1.

[6] If the independent accountant was disclaiming an opinion due to a scope limitation, this paragraph would be omitted. (See paragraphs 22.12 and 22.19 on "Disclaimer of Opinion.")

plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 20X5.

In our opinion, the 20X4 financial statements referred to above present fairly, in all material respects, the financial position of XYZ Bank as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Emphasis of a Matter

22.09 In some circumstances, the independent accountant may wish to emphasize a matter regarding the financial statements but, nevertheless, intends to express an unqualified opinion. For example, the independent accountant may wish to emphasize that the bank or savings institution is a subsidiary of a holding company or that it has had significant transactions with related parties, or the independent accountant may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information should be presented in a separate paragraph of the independent accountant's report that may precede or follow the opinion paragraph. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding an institution's failure to meet minimum regulatory capital standards on the institution's financial statements (Note that in this illustration, this emphasis of a matter is not a going-concern matter.)

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 20X5 and 20X4, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[7] Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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[7] See footnote 1.

As discussed in Note XX to the financial statements, at December 31, 20X5, the Institution failed to meet the risk-based capital requirement established by the Federal Deposit Insurance Corporation (FDIC). The Institution has filed, and the FDIC has accepted, a capital plan for attaining the required level of regulatory risk-based capital by December 31, 20X6.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 20X5 and 20X4, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Qualified Opinion

22.10 AU section 508.20–.63 describes certain circumstances that may require the independent accountant to qualify his or her opinion on financial statements. A qualified opinion states that, except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is expressed when—

a. There is a lack of sufficient competent audit evidence or there are restrictions on the scope of the audit that have led the independent accountant to conclude that an unqualified opinion cannot be expressed and the independent accountant has concluded not to disclaim an opinion.

b. The independent accountant believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

Adverse Opinion

22.11 AU section 508.58–.60 describes adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed when, in the independent accountant's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When the independent accountant expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for the adverse opinion and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

Disclaimer of Opinion

22.12 AU section 508.61–.63 describes disclaimers of opinion. AU section 508.61 says:

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

22.13 AU section 508.62 says that a disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statement. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from GAAP (see paragraphs .35–.57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He should state that the scope of his audit was not sufficient to warrant the expression of an opinion. The audit should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, he should also disclose any other reservations he has regarding fair presentation in conformity with GAAP.

Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting

22.14 Title II of the Credit Union Membership Access Act of 1998 (CUMAA), requires all federally insured credit unions with assets of $10 million or more to follow generally accepted accounting principles. Credit unions with assets under $10 million may use a basis of accounting other than GAAP. AU section 623.05 (AICPA, *Professional Standards*, vol. 1) recognizes bases of accounting that reporting entities use to comply with the requirements or financial reporting provisions of governmental regulatory agencies to whose jurisdiction they are subject as comprehensive bases of accounting other than GAAP, and provides guidance on reporting on an Other Comprehensive Basis Accounting (OCBOA) financial statements.

22.15 The following is an example of an auditor's report on financial statements prepared in conformity with a comprehensive basis of accounting prescribed by the National Credit Union Administration (NCUA). Only credit unions with assets under $10 million may use a basis of accounting other than GAAP.

<u>Independent Auditor's Report</u>

To the [*Institution, Board of Directors, or Stockholders*]:

We have audited the accompanying statements of financial condition—regulatory basis of XYZ Credit Union as of December 31, 20X5 and 20X4, and the related statements of income—regulatory basis, members' equity—regulatory basis, and cash flows—regulatory basis for the years then ended. These financial statements are the responsibility of the credit union's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting principles prescribed or permitted by the National Credit Union Administration (NCUA), which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 20X5 and 20X4, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Credit Union and the NCUA, and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

Members' Shares Reported as Equity

22.16 As discussed in paragraph 13.39, GAAP require that members' shares be reported as liabilities in the statement of financial condition. If members' shares are not reported as such, or in any other manner in which it is not unequivocal that members' shares are liabilities, and the shares are material to the financial statements, the auditor should express a qualified opinion or, in certain cases, an adverse opinion on the financial statements unless the financial statements are prepared using a comprehensive basis of accounting other than GAAP (see paragraphs 22.14 and 22.15). An illustration of a report modified in those circumstances follows.

<u>Qualified Opinion</u>

[*Same first and second paragraphs as the standard report*]

The credit union has reported members' shares as equity in the accompanying statements of financial condition that, in our opinion, should be reported as liabilities in order to conform with generally accepted accounting principles (GAAP). If these shares were properly reported, liabilities would increase and equity would decrease by $_____ and $_____ as of December 31, 20X5 and 20X4, respectively.

In our opinion, except for the effects of reporting members' shares as equity as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Credit Union as of December 31, 20X5 and 20X4, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Communication of Internal Control Related Matters

22.17 The independent auditor may become aware of reportable conditions (audit of a nonissuer) or significant deficiencies (audit of an issuer) in internal control during the performance of the audit. AU section 325 (AICPA, *Professional Standards*, vol. 1) requires that such reportable conditions be reported to the audit committee or its equivalent. In a credit union, these matters are normally communicated to the supervisory committee.

22.18 AU section 325.09–.19 describes the auditor's report on internal control based solely on a study and evaluation made as part of an audit. AU section 325.07–.08, addresses reporting on matters noted in performing agreed upon criteria. In an audit of financial statements only, conducted in accordance with PCAOB Standards, refer to AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1).[†] For an integrated audit of financial statements and internal control over financial reporting conducted in accordance with PCAOB Standards, refer to Auditing Standards No. 2, paragraphs 207–214 (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards").

22.19 AU section 325, *Communicating Internal Control Related Matters Identified in an Audit*. The new standard is effective for audits of financial statements for periods ending on or after December 15, 2006, early application is permitted. AU section 325, establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. AU section 325 also requires that certain communications be in writing.

Reports on Supervisory Committee Audits

22.20 The form and content of reports that are currently prepared by independent auditors in connection with supervisory committee audits reflect a diversity of practice. As a result, supervisory committee members may not understand the fundamental differences between an engagement for the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement in connection with a supervisory committee audit and an audit of a credit union's financial statements in accordance with GAAS. This is of particular concern when the limitations of the supervisory committee audit relate to areas of higher risk in the credit union industry. Further, supervisory committee members may incorrectly assume that the application of agreed-upon procedures included obtaining an understanding of the credit union's internal control similar to that obtained in an audit of the credit union's financial statements in accordance with GAAS.

22.21 Independent auditors' reports on audits of financial statements should comply with the reporting provisions contained in applicable AICPA, *Professional Standards*. AU section 508 (AICPA, *Professional Standards*, vol. 1) provides guidance on reports on audited financial statements, and paragraph .62 of AU section 508 states that a disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.

[†] The PCAOB has recently issued Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. For auditors' of issuers this standard established a voluntary engagement reporting on whether previously reported material weaknesses continue to exist. See the PCAOB Web site at www.pcaobus.org for information.

22.22 Independent auditors' reports on the performance of agreed-upon procedures in connection with a supervisory committee audit should be prepared in accordance with Statement on Standards for Attestation Engagements (SSAE). AT sections 101–701, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1),[8] states that such reports should contain the following elements:

- A title that includes the word *independent*
- Reference to the specified elements, accounts, or items of a financial statement of an identified entity and the character of the engagement
- Identification of specified parties
- The basis of accounting of the specified elements, accounts, or items of a financial statement unless clearly evident
- A statement that the procedures performed were those agreed to by the specified parties identified in the report
- Reference to standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures
- A list of the procedures performed (or reference thereto) and related findings
- Where applicable, a description of any agreed-upon materiality limits
- A statement that the accountant was not engaged to and did not perform an audit of the specified elements, accounts, or items; and a statement that if the accountant had performed additional procedures, other matters might have come to his attention that would have been reported
- A disclaimer of opinion on the effectiveness of internal control over financial reporting or any part thereof when the accountant has performed procedures on part of an entity's internal control over financial reporting
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the specified parties and is not intended to be and should not be used by anyone other than the specified parties
- Where applicable, reservations or restrictions concerning procedures or findings (as discussed in AT sections 201.33, 201.35, 201.39, and 201.40)
- Where applicable, a description of the nature of the assistance provided by a specialist. AT section 201 also states that the accountant should not provide negative assurance about whether

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[8] The AICPA is revising the exposure draft titled "AT 501, *Reporting on an Entity's Internal Control Over Financial Reporting*." Some of the matters the task force are taking into account when revising AT Section 501 are (1) comments received on the original exposure draft issued on March 18, 2003; (2) PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting*; and (3) the views of insurance companies, financial institutions, related regulators, and the U.S. Government Accountability Office.

the specified elements, accounts, or items of a financial statement are fairly stated in relation to established or stated criteria.[9]

22.23 As mentioned earlier, some regulatory agencies require that supervisory committee audit reports include financial statements or other data. In such instances, the supervisory committee usually includes the auditor's report on the application of agreed-upon procedures and the unaudited financial statements or data in its report to the regulatory agency.

22.24 An independent accountant may be requested to perform specific procedures in conjunction with a compilation or review of financial statements. The procedures employed in compilation and review engagements, and reports thereon, should comply with the provisions of SSARS No. 1, as amended, which states that any procedures that the accountant might have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, should not be described in his or her report. That provision, however, would not preclude the independent accountant from issuing a separate, special-purpose report on the nature and extent of procedures performed in accordance with SSAE No. 10.

Example Report on the Application of Agreed-Upon Procedures Performed in Connection With a Supervisory Committee Audit

22.25 The following is an example of a report on the application of agreed-upon procedures performed in connection with a supervisory committee audit.

> Supervisory Committee
> XYZ Credit Union
>
> We have performed the procedures enumerated in the attached supplement, which were agreed to by [*list specified parties,*[10] *ordinarily the Supervisory Committee of XYZ Credit Union*], solely to assist you in connection with your supervisory audit of XYZ Credit Union conducted pursuant to section 701.12 of the National Credit Union Administration regulations. The procedures performed by us and enumerated in the attached supplement are in accordance with the minimum procedures described in Appendix A of the National Credit Union Administration's Supervisory Committee Guide for Federal Credit Unions. Because the committee is responsible to ensure that a complete set of procedures is performed and because Appendix A procedures are designed for smaller, less complex credit unions, we performed other procedures at the committee's request. This engagement to apply agreed-upon procedures was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of the specified parties. Consequently, we make no representation regarding the sufficiency of the procedures described in

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[9] When the accountant consents to the inclusion of his or her report on the results of applying agreed-upon procedures in a document or written communication containing the entity's financial statements, the accountant should look to AU section 504, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1), or to Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), and Statement on Standards for Attestation Engagements (SSAEs), as appropriate, for guidance on his or her responsibility pertaining to the financial statements.

[10] The NCUA should not be named as a specified party.

the supplement either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an audit, the objective of which would be the expression of an opinion on the specified elements, accounts, or items. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

____

[*Signature of Independent Auditor*]

[*City, State*]

[*Date*]

Supplement to Illustrative Report[11]

Loans

We obtained trial balances or subsidiary ledgers of the notes or both from the service center and reconciled the totals to the general ledger in the following amounts:

Account	*Amount Outstanding at June 30, 20X0*
Business loans	$
Consumer loans	
Real estate loans	
Participations purchased	
	$

Certain [*specify number*] loans, including lines of credit that had not been fully funded, were selected for confirmation directly with borrowers. The results of our confirmation efforts are summarized in Schedule A. Borrowers with lines of credit of $_____ or more as of June 30, 20X0, who did not respond to confirmation requests by July 31, 20X0, are listed in Schedule B.

We obtained and read selected [*specify number*] loan agreements on hand, as well as readily marketable securities, and other collateral

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[11] *Note:* This supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. The accounts and procedures described in the report should generally conform to those described in the engagement letter. Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

Also, the accounts examined and procedures performed as described in this supplement consist of the minimum procedures described in Appendix A to the NCUA's Supervisory Committee Guide for Federal Credit Unions and optional procedures. Refer to Appendix A of the NCUA Guide for a description of the minimum procedures to be performed.

recorded as held in respect of certain selected secured loans were inspected.

We obtained the Credit Union's listing of business loans, real estate loans, and participations purchased five days or more past due as of June 30, 20X0, and compared it with a similar listing as of July 31, 20X0. The following loans were listed in both reports:

[*List loans.*]

Similarly, we obtained the Credit Union's listing of consumer loans ten days or more past due as of June 30, 20X0, and compared it to a like listing as of July 31, 20X0. The following loans were listed in both reports:

Name	*Due Date*	*Amount Outstanding at June 30, 20X0*	*Amount Outstanding at July 31, 20X0*
________	________	________	________

Loan participations [*Specify "all" or number*] "sold" and serviced by the credit union were confirmed with the purchasers, without exception.

We obtained the Credit Union's listing of overdrafts as of June 30, 20X0, and compared it to a similar listing as of July 31, 20X0. The following overdrafts were listed in both reports:

Name	*Date of Overdraft*	*Amount at June 30, 20X0*	*Amount at July 31, 20X0*
________	________	________	________

The interest rates and repayment terms of five judgmentally selected loans granted to directors, officers, and other related parties during May 20X0 were compared to the interest rate and repayment terms of similar loans granted to outsiders during the same month. No instances of the granting of favorable interest rates or repayment terms to directors, officers, and other related parties were found.

The maturity date and amount of loan commitments in excess of $50,000 were confirmed as of May 20X0 by the customers for whose benefit they were issued, without exception. We judgmentally selected five loan commitments and tested the computation of deferred fee income. [*Specify results of computations.*]

Requests for confirmation of loan balances could not be mailed to the following borrowers due to lack of sufficient addresses:

Name	*Account Number*	*Balance as of June 30, 20X0*
________	________	________

Lack of Evaluation of Collectibility and Adequacy of Collateral

As noted in our engagement letter and report, we did not evaluate the collectibility of loans or the adequacy of collateral thereon.

Lack of Evaluation of the Allowance for Loan Losses

As noted in our engagement letter and report, we did not evaluate the reasonableness of the allowance for loan losses determined by management.

Confirmation Statistics

[Confirmation Date]

	Loans	Share Draft Accounts	Savings Accounts	Certificates of Deposit
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received to total circularized				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				
Replies received				
Percent replies received to total circularized				
Selected but not circularized				
Not delivered by post office				

Confirmation Requests Not Mailed

	Name and Address	Reason for Not Mailing	Balance as of [Audit Date]
Loans			
Share draft accounts			
Savings accounts			
Certificates of deposit			

Note: An indication of how the samples were selected (that is, on a random, statistical, or judgmental basis), as well as an indication of the type of confirmation (that is, positive or negative requests), should be included. If the loans are categorized by type in the report, similar categories would normally be used in this schedule.

Appendix A

FDI Act Reporting Requirements

Section 36 of the Federal Deposit Insurance (FDI) Act requires reports by managements and independent accountants on financial statements and internal controls over financial reporting. It also establishes minimum qualifications for independent accountants serving the affected institutions. The Section 36 provisions, as summarized below, apply to each Federal Deposit Insurance Corporation (FDIC)-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. Despite the asset threshold, Section 36 does not override any non-FDI Act requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[1]

On November 28, 2005, the FDIC amended Part 363 of its regulations by raising the asset-size threshold from $500 million to $1 billion for internal control assessments by management and external auditors. For institutions between $500 million and $1 billion in assets, only a majority, rather than all, of the members of the audit committee, who must be outside directors, must be independent of management. The amendments take effect December 28, 2005, and apply to institutions whose fiscal years end on or after September 30, 2005.

To implement Section 36, the FDIC issued both a final regulation[2] and accompanying guidelines and interpretations (guidelines), which became effective July 2, 1993. The general requirements are summarized below; however, the side-by-side analysis of the detailed regulation and guidelines presented in the exhibit that follows should be read.

Annual Report. Management is required to prepare, annually, a report that includes the following:[3,4]

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP)

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[1] The FDIC has adopted the FFIEC Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations. It replaces the FDIC's "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" and is effective for fiscal years beginning on or after January 1, 2000. The other banking agencies have also adopted the interagency policy statement. The interagency policy statement encourages institutions to adopt an annual external auditing program and, where practicable, to establish an audit committee composed entirely of outside directors. The interagency policy statement states that the banking agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The statement also describes two alternatives to a financial statement audit that an institution may elect to have performed annually in order to have an acceptable external auditing program.

[2] The regulation and guidelines implementing FDI Act Section 36 are codified in Title 12 of the Code of Federal Regulations (CFR) Part 363. The regulation was published in the *Federal Register* on June 2, 1993, and in FDIC FIL 41-93 and Office of the Comptroller of the Currency (OCC) Banking Bulletin (BB) 93-45. Subsequent changes to the regulation were published in the *Federal Register* on February 21, 1996, November 28, 1997, and November 28, 2005.

[3] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in Section 363.1 of the rule and in guidelines 2-4.

[4] The content of the certification required by Section 302 of the Sarbanes-Oxley Act is sufficiently different from the content of the management report required by Section 36 and Part 363 that an insured institution that is a public company, or a subsidiary of a public holding company, *may not* submit a Section 302 certification in place of the required management report.

- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting
- A written assertion about the institution's compliance during the year with (*a*) federal laws and regulations relative to insider loans, and (*b*) federal and state laws and regulations relative to dividend restrictions

Management must also include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations.

Management must engage an independent accountant to provide the following reports annually:

- An audit report on the GAAP-basis financial statements
- An examination-level attestation report on management's assertion about financial reporting controls

The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls is to be performed in accordance with the AICPA's Statements on Standards for Attestation Engagements (SSAE).

The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

All of management's reports are made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls is also made publicly available. Any management letter, while filed with the FDIC, and the appropriate federal banking agency (and any appropriate state bank supervisor) is not included in the annual report and, therefore, is not publicly available.

Qualifications of Independent Accountants. Acceptance of an engagement to report under Section 36 is conditioned on the independent accountant being enrolled in a practice-monitoring program. Registration with the Public Company Accounting Oversight Board, or enrollment in the AICPA peer review program, should satisfy this requirement.

Another condition of the engagement is that the independent accountant agree to provide regulators with access to workpapers related to the two engagement reports. Although this condition is not explicitly expressed in the law or regulations, the implementing guidelines also call for providing copies of workpapers to regulators. Independent accountants should be familiar with Auditing Interpretation No. 1 of AU section 9339.01–.15, titled "Providing Access to or Copies of Audit Documentation to a Regulator" (AICPA, *Professional Standards*, vol. 1). In December of 2005 the Auditing Standards Board issued Statement of Auditing Standards (SAS) No. 103, *Audit Documentation*. SAS No. 103 supersedes AU section 339A, *Audit Documentation* (AICPA *Professional Standards*, vol. 1) and amends AU section 530, *Dating of the Independent Auditor's Report*, (AICPA *Professional Standards*, vol. 1). The Statement is effective for audits of financial statements for periods ending on or after December 15, 2006 with earlier application permitted.

The accountant must meet the independence requirements and interpretations of the AICPA and the SEC and its staff.

The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. An independent accountant must also file a peer review report within fifteen days of acceptance of the report.

Enforcement Actions Against Accountants. Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the regulatory agencies have not yet proposed or published rules or guidelines to implement this statutory requirement.[5]

Communication With Auditors. Each subject institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

Audit Committees. Each subject institution must have an independent audit committee made up entirely of outside directors independent of management. One of the audit committee's required duties is to review with management and the independent accountant the reports required under Section 36. A list of other suggested duties is included in the guidelines, some of which relate to the independent accountant. Audit committees of institutions having $3 billion or more in assets must include members with banking or related financial management expertise, have access to their own outside counsel, and not include any large customers of the institution.

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[5] Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate federal banking agency may "remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services" required by Section 36. The federal banking agencies are expected to jointly issue rules to implement this provision.

Audit and Reporting Requirements

Reprinted below are Part 363 of Title 12 of the Code of Federal Regulations (12 CFR) Part 363—Annual Independent Audits and Reporting Requirements (left column) and Appendix A to Part 363—Guidelines and Interpretations (right column). The regulation and appendix were published in the June 2, 1993 *Federal Register*. Amendments to the regulation were also published in the February 21, 1996, November 28, 1997 and November 28, 2005 *Federal Register*.

Regulation	Guidelines
§363.1 SCOPE	
(a) Applicability. This part applies with respect to fiscal years of insured depository institutions which begin after December 31, 1992. This part does not apply with respect to any fiscal year of any insured depository institution, the total assets of which, at the beginning of such fiscal year, are less than $500 million.	1. Measuring Total Assets. To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year.
	2. Insured Branches of Foreign Banks. Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on non-related parties reported on its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (form FFIEC 002).
(b) Compliance by subsidiaries of holding companies. (1) The audited financial statements requirement of 363.2(a) may be satisfied for an insured depository institution that is a subsidiary of a holding company by audited financial statements of the consolidated holding company. (2) The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the holding company if:	3. Compliance by Holding Company Subsidiaries. Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompanied by a cover letter identifying all subsidiary institutions to which they pertain. An institution filing holding company consolidated financial statements as permitted by §363.1(b) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in section 36(i) must satisfy the remaining provisions of the statute and this part on an individual institution basis, and maintain its own audit committee. Multi-tiered holding companies may satisfy all requirements of this part at any level.
(i) The services and functions comparable to those required of the insured depository institution by this part are provided at the holding company level; and	4. Comparable Services and Functions. Services and functions will be considered "comparable" to those required by this part if the holding company:
(ii) The insured depository institution has as of the beginning of such fiscal year:	(*a*) Prepares reports used by the subsidiary institution to meet the requirements of this part;

Regulation	Guidelines
(A) total assets of less than $5 billion; or	(*b*) Has an audit committee that meets the requirements of the part appropriate to its largest subsidiary institution; and
(B) total assets of $5 billion or more and a composite CAMEL rating of 1 or 2.	(*c*) Prepares and submits the management assessments of the effectiveness of the internal control structure and procedures for financial reporting ("internal controls"), and compliance with the Designated Laws defined in guideline 12 based on information concerning the relevant activities and operations of those subsidiary institutions within the scope of the Rule.
(iii) The appropriate federal banking agency may revoke the exception in paragraph (b)(2) of this section for any institution with total assets in excess of $9 billion for any period of time during which the appropriate federal banking agency determines that the institution's exemption would create a significant risk to the affected deposit insurance fund.	
§363.2 ANNUAL REPORTING REQUIREMENTS	
(a) Audited financial statements. Each insured depository institution shall prepare annual financial statements in accordance with generally accepted accounting principles which shall be audited by an independent public accountant.	5. Annual Financial Statements. Each institution should prepare comparative annual consolidated financial statements (balance sheets, statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with generally accepted accounting principles (GAAP) for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared.
	6. Holding Company Statements. Subsidiary institutions may file copies of their holding company's audited financial statements filed with the Securities and Exchange Commission (SEC) or prepared for their FR Y-6 Annual Report under the Bank Holding Company Act of 1956.
	7. Insured Branches of Foreign Banks. An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for the two preceding fiscal years:
	(*a*) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk;
	(*b*) Schedules RAL and L of form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or

(continued)

Regulation	*Guidelines*
	(*c*) With written approval of the appropriate federal banking agency, consolidated financial statements of the parent bank.
(b) Management report. Each insured depository institution annually shall prepare, as of the end of the institution's most recent fiscal year, a management report signed by its chief executive officer and chief accounting or chief financial officer which contains:	8. Management Report. Management should perform its own investigation and review of the effectiveness of internal controls and compliance with the Designated Laws defined in guideline 12. Management also should maintain records of its determinations and assessments until the next federal safety and soundness examination, or such later date as specified by the FDIC or appropriate federal banking agency. Management should provide in its assessment of the effectiveness of internal controls, or supplementally, sufficient information to enable the accountant to report on its assertion. The management report of an insured branch of a foreign bank should be signed by the branch's managing official if the branch does not have a chief executive or financial officer.
(1) A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and {{12-30-05 p.3162}} regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency; and	
(2) An assessment by management of the institution's compliance with such laws and regulations during such fiscal year; and	
(3) For an institution with total assets of $1 billion or more at the beginning of such fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year	
	9. Safeguarding of Assets. The FDIC believes "safeguarding of assets," as the term relates to internal controls policies and procedures regarding financial reporting, and which has precedent in accounting literature, should be addressed in the management report and the independent public accountant's attestation discussed in guideline 18. Testing the existence of and compliance with internal controls on the management of assets, including loan underwriting and documentation, represents a reasonable implementation of section 36. [1] The FDIC expects such internal control to be encompassed by the assertion in the management report, but the term "safeguarding of assets" need not be specifically stated. The FDIC does not require the accountant to attest to the adequacy of the safeguards, but does require the accountant to determine whether safeguarding policies exist.

Regulation | *Guidelines*

10. Standards for Internal Controls. Each institution should determine its own standards for establishing, maintaining and assessing the effectiveness of its internal controls.[2]

11. Service Organizations. Although service organizations should be considered in determining if internal controls are adequate, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. On-site reviews of service organizations may not be necessary to prepare the reports required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.

12. Compliance With Laws and Regulations. The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions (the Designated Laws). Table 1 of Appendix A * lists the designated federal laws and regulations pertaining to insider loans and dividend restrictions that are applicable to each type of institution.

§363.3 INDEPENDENT PUBLIC ACCOUNTANT

(a) Annual audit of financial statements. Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards and section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles.

13. General Qualifications. To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by section 36(g) (3)(A)(i), the accountant must agree to provide copies of any workpapers, policies, and procedures relating to services performed under this part.

14. Independence. The independent public accountant also should be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff.

15. Peer Reviews. As required by section 36(g)(3) (A)(ii), the independent public accountant must have received, or be enrolled in, a peer review that meets acceptable guidelines. The following peer review guidelines are acceptable:

(*a*) The external peer review should be conducted by an organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

(continued)

Regulation | Guidelines

(*b*) The peer review should be generally consistent with AICPA standards; [3] and

(*c*) The review should include, if available, at least one audit of an insured depository institution or consolidated financial holding company. Peer review working papers are to be retained for 120 days after the peer review report is filed with the FDIC, and be made available to the FDIC upon request, in a form consistent with the SEC's agreement with the accounting profession.

16. Filing Peer Review Reports. Within 15 days of receiving notification that the peer review has been accepted, or before commencing any audit under this part, whichever is earlier, two copies of the peer review report, accompanied by any letter of comments and letter of response, should be filed by the independent public accountant (if not already on file) with the FDIC, Registration and Disclosure Section, 550 17th Street, NW, Washington, DC 20429, where they will be available for public inspection. All corrective action required under any qualified peer review report should have been taken prior to commencing services under this rule.

17. Information to Independent Public Accountant. Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified under section 38 of the FDI Act, and any correspondence from the appropriate federal banking agency concerning compliance with this part.

(b) Additional reports. For each insured depository institution with total assets of $1 billion or more at the beginning of the institution's fiscal year, such independent public accountant shall examine, attest to, and report separately on, the assertion of management concerning the institution's internal control structure and procedures for financial reporting. The attestation shall be made in accordance with generally accepted standards for attestation engagements.

18. Attestation Report. The independent public accountant should provide the institution with an internal controls attestation report, and any management letter, at the conclusion of the audit as required by section 36(c)(1). If a holding company subsidiary relies on its holding company management report, the accountant may attest to and report on the management's assertions in one report, without reporting separately on each subsidiary covered by the Rule. The FDIC has determined that management letters are exempt from public disclosure.

19. Reviews with Audit Committee and Management. The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also may be appropriate for the accountant to review its findings with the institution's board of directors and management.

Regulation

(c) Notice by accountant of termination of services. An independent public accountant performing an audit under this part who ceases to be the accountant for an insured depository institution shall notify the FDIC and the appropriate federal banking agency in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination.

§363.4 FILING AND NOTICE REQUIREMENTS

(a) Annual reporting. Within 90 days after the end of its fiscal year, each insured depository institution shall file with each of the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, two copies of:

(1) An annual report containing audited annual financial statements, the independent public accountant's report thereon, management's statements and assessments, and the independent public accountant's attestation report concerning the institution's internal control structure and procedures for financial reporting as required by §§363.2(a) and 363.3(a), 363.2(b), and 363.3(b) respectively; and

(b) Public availability. The foregoing annual report in paragraph (a) of this section shall be available for public inspection.

Guidelines

20. Notice of Termination. The notice required by §363.3(c) should state whether the independent accountant agrees with the assertions contained in any notice filed by the institution under §363.4(d), and whether the institution's notice discloses all relevant reasons.

21. Reliance on Internal Auditors. Nothing in this part or this appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.

22. Place for Filing. Except for peer review reports filed pursuant to Guideline 16, all reports and notices required by, and other communications or requests made pursuant to, the Rule should be filed as follows:

(*a*) FDIC: Appropriate FDIC Regional or Area Office (Supervision and Consumer Protection), i.e., the FDIC regional or area office in the FDIC region or area that is responsible for monitoring the institution or, in the case of a subsidiary institution of a holding company, the consolidated company. A filing made on behalf of several covered institutions owned by the same parent holding company should be accompanied by a transmittal letter identifying all of the institutions covered;

(*b*) Office of the Comptroller of the Currency (OCC): appropriate OCC Supervisory Office;

(*c*) Federal Reserve: appropriate Federal Reserve Bank;

(*d*) Office of Thrift Supervision (OTS): appropriate OTS District Office; and

(*e*) State bank supervisor: the filing office of the appropriate state bank supervisor.

23. Relief from Filing Deadlines. Although the reasonable deadlines for filings and other notices established by this part are specified, it recognizes some institutions occasionally may be confronted with extraordinary circumstances beyond their reasonable control that may justify extensions of a deadline. In that event, upon written application from an insured depository institution, setting forth the reasons for any requested extension, the FDIC or appropriate federal banking agency may, for good cause shown, extend the deadline for a period not to exceed 30 days.

(continued)

Regulation	Guidelines
	24. Public Availability. Each institution's annual report should be available for public inspection at its main and branch offices no later than 15 days after it is filed with the FDIC. Alternatively, an institution may elect to mail one copy of its annual report to any person who requests it. The annual report should remain available to the public until the annual report for the next year is available. An institution may use its annual report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR part 350.
(c) Independent accountant's reports. Each insured depository institution shall file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, a copy of any management letter, qualification, or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to this part within 15 days after receipt.	25. Independent Public Accountant's Report. Section 36(h)(2)(A) requires that, within 15 days of receipt by an institution of any management letter or other report, such letter or other report shall be filed with the FDIC, any appropriate federal banking agency and any appropriate state bank supervisor. Institutions and their accountants are encouraged to coordinate preparation and delivery of audit and attestation reports and filing the annual report, to avoid duplicate filings.
(d) Notice of engagement or change of accountants. Each insured depository institution shall provide, within 15 days, after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.	26. Notices Concerning Accountants. Institutions should review and satisfy themselves as to compliance with the required qualifications set forth in guidelines 13-15 before engaging an independent public accountant. With respect to any selection, change or termination of an accountant, institutions should be familiar with the notice requirements in guideline 21, and should send a copy of any notice under §363.4(d) to the accountant when it is filed with the FDIC. An institution which files reports with its appropriate federal banking agency under, or is a subsidiary of a holding company which files reports with the SEC pursuant to, the Securities Exchange Act of 1934 may use its current report (*e.g.*, SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of this part.
363.5 AUDIT COMMITTEES	
(a) Composition and duties. Each insured depository institution shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution, and the duties of which shall include reviewing with management and the independent public accountant the basis for the reports issued under this part.	27. Composition. The board of directors of each institution should determine if outside directors meet the requirements of section 36 and this part. At least annually, the board of an institution with $1 billion or more in total assets at the beginning of its fiscal year should determine whether all existing and potential audit committee members are "independent of management of the institution" and the board of an institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year should determine whether the {{12-30-05 p.3162.07}}majority of all existing

Regulation | Guidelines

and potential audit committee members are "independent of management of the institution." Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch.

(1) Each insured depository institution with total assets of $1 billion or more as of the beginning of its fiscal year shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution.

(2) Each insured depository institution with total assets of $500 million or more but less than $1 billion as of the beginning of its fiscal year shall establish an audit committee of its board of directors, the members of which shall be outside directors, the majority of whom shall be independent of management of the institution. The appropriate Federal banking agency may, by order or regulation, permit the audit committee of such an insured depository institution to be made up of less than a majority of outside directors who are independent of management, if the agency determines that the institution has encountered hardships in retaining and recruiting a sufficient number of competent outside directors to serve on the audit committee of the institution.

(3) An outside director is a director who is not, and within the preceding fiscal year has not been, an officer or employee of the institution or any affiliate of the institution.

28. "Independent of Management" Considerations. In determining whether an outside director is independent of management, the board should consider all relevant information. This would include considering whether the director:

(*a*) Has previously been an officer of the institution or any affiliate of the institution;

(*b*) Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;

(*c*) Is a relative of an officer or other employee of the institution or its affiliates;

(*d*) Holds or controls, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates; and

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Regulation	*Guidelines*
	(*e*) Has outstanding extension of credit from the institution or its affiliates. 29. Lack of Independence. An outside director should not be considered independent of management if such director owns or controls, or has owned or controlled within the preceding fiscal year, assets representing 10 percent or more of any outstanding class of voting securities of the institution. 30. Holding Company Audit Committees. When an insured depository institution subsidiary fails to meet the requirement for the holding company exception in §363.1(b)(2) or maintain its own separate audit committee to satisfy the requirements of this part, members of the independent audit committee of the holding company may serve as the audit committee of the subsidiary institution if they are otherwise independent of management, of the subsidiary, and, if applicable, meet any other requirements for a large subsidiary institution covered by this part. However, this does not permit officers or employees of a holding company to serve on the audit committee of its subsidiary institutions. When the subsidiary institution satisfies the requirements for the holding company exception in §363.1(b)(2), members of the audit committee of the holding company should meet all the membership requirements applicable to the largest subsidiary depository institution and may perform all the duties of the audit committee of a subsidiary institution, even though such holding company directors are not directors of the institution. 31. Duties. The audit committee should perform all duties determined by the institution's board of directors. The duties should be appropriate to the size of the institution and the complexity of its operations, and include reviewing with management and the independent public accountant the basis for the reports issued under §363.2(a) and (b) and §363.3(a) and (b). Appropriate additional duties could include: (*a*) Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates; (*b*) Reviewing with management and the accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal controls, including the prevention or detection of management override or compromise of the internal control system;

Regulation	Guidelines
	(*c*) Reviewing with management and the accountant the institution's compliance with laws and regulations;
	(*d*) Discussing with management the selection and termination of the accountant and any significant disagreements between the accountant and management; and
	(*e*) Overseeing the internal audit function. It is recommended that audit committees maintain minutes and other relevant records of their meetings and decisions.
(b) Committees of large institutions. The audit committee of any insured depository institution that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution. If a large institution is a subsidiary of a holding company and relies on the audit committee of the holding company to comply with this Rule, the holding company audit committee shall not include any members who are large customers of the subsidiary institution.	32. Banking or Related Financial Management Expertise. At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such required expertise if the person has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria.
	33. Large Customers. Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of §363.5(b).
	34. Access to Counsel. The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel. It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate, and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously participated personally and substantially as outside counsel to the committee.

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Regulation | Guidelines

35. Forming and Restructuring Audit Committees. Audit committees should be formed within four months of the effective date of this part. Some institutions may have to restructure existing audit committees to comply with this part. No regulatory action will be taken if institutions restructure their audit committees by the earlier of their next annual meeting of stockholders, or one year from the effective date of this part.

36. Modifications of Guidelines. The FDIC Board of Directors has delegated to the Director of the FDIC's Division of Supervision authority to make and publish in the *Federal Register* minor technical amendments to the Guidelines, in consultation with the other appropriate federal banking agencies, to reflect the implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification. Any material modification or amendment will be subject to review and approval of the FDIC Board of Directors.

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[1] It is management's responsibility to establish underwriting policies and to make credit decisions. The auditor's role is to test compliance with management's policies relating to financial reporting.

[2] In considering what information is needed on safeguarding of assets and standards for internal controls, management may review guidelines provided by its primary federal regulator; FDIC's Division of Supervision and Consumer Protection (DSC) Manual of Examination Policies; the Federal Reserve Board's Commercial Bank Examination Manual and other relevant regulations; the Office of Thrift Supervision's Thrift Activities Handbook; the Comptroller of the Currency's Handbook for National Bank Examiners; standards published by professional accounting organizations, such as the American Institute of Certified Public Accountant's (AICPA) AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), the Committee on Sponsoring Organizations (COSO) of the Treadway Commission's *Internal Control—Integrated Framework*, including its addendum on safeguarding of assets; and other internal control standards published by the AICPA, other accounting or auditing professional associations, and financial institution trade associations.

[*] See the end of these reprinted regulations for Table 1 to Appendix A of Part 363.

[3] These would include Standards for Performing and Reporting on Peer Reviews, contained in volume 2 of the AICPA's *Professional Standards*.

TABLE 1 TO APPENDIX A

Designated Federal Laws and Regulations Applicable to

		National banks	*State member banks*	*State non-member banks*	*Savings associations*
Insider Loans—Parts and/or Sections of Title 12 of the United States Code					
375a	Loans to Executive Officers of Banks	✓	✓	(1)	(1)
375b	Prohibitions Respecting Loans and Extensions of Credit to Executive Officers and Directors of Banks, Political Campaign, Committees, etc.	✓	✓	(1)	(1)
1468(b)	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders	....	....	....	✓
1828(j)(2)	Provisions Relating to Loans, Extensions of Credit, and Other Dealings Between Member Banks and Their Affiliates, Executive Officers, Directors, etc.	....	....	✓	{{12-30-05 p.3162.09}} ....
1828(j)(3)(B)	Extensions of Credit Applicability of Provisions Relating to Loans, Extensions of Credit, and Other Dealings Between Insured Branches of Foreign Banks and Their Insiders.	(2)	....	(3)	....
Parts and/or Sections of Title 12 of the Code of Federal Regulations					
23.5	Applications of Legal Lending Limits; Restrictions on Transactions With Affiliates.	✓	....	....	....
31	Extensions of Credit to National Bank Insiders	✓	....	....	....
215	Subpart A—Loans by Member Banks to Their Executive Officers, Directors, and Principal Shareholders	✓	✓	(4)	(5)
	Subpart B—Reports of Indebtedness of Executive Officers and Principal Shareholders of Insured Nonmember Banks	✓	✓	(4)	(5)
337.3	Limits on Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Insured Nonmember Banks	....	....	✓	....
349.3	Reports by Executive Officers and Principal Shareholders	....	....	✓	....

563.43	Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders	....	....	....	✓

Dividend Restrictions—Parts and/or Sections of Title 12 of the United States Code

56	Prohibition on Withdrawal of Capital and Unearned Dividends	✓	✓	....	....
60	Dividends and Surplus Funds	✓	✓	....	....
1467a(f)	Declaration of Dividends	....	....	....	✓
1831o	Prompt Corrective Action—Dividend Restrictions	✓	✓	✓	✓

Parts and/or Sections of Title 12 of the Code of Federal Regulations

5.61	Payment of dividends; capital limitation	✓	....	....	....
5.62	Payment of dividends; earnings limitation	✓	....	....	....
6.6	Prompt Corrective Action—Dividend Restrictions	✓	....	....	....
7.6120	Dividends Payable in Property Other Than Cash	✓	....	....	....
208.19	Payments of Dividends	....	✓	....	....
208.35	Prompt Corrective Action	....	✓	....	....
325.105	Prompt Corrective Action	....	....	✓	....
563.134	Capital Distributions	....	....	....	✓
565	Prompt Corrective Action	....	....	....	✓

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(1) Subsections (g) and (h) only.

(2) Applies only to insured federal branches of foreign banks.

(3) Applies only to insured state branches of foreign banks. {{12-30-05 p.3162.10}}

(4) See 12 CFR parts 337.3 and 349.3.

(5) See 12 CFR part 563.43.

Appendix B

Regulatory Accounting Practices (RAP) and RAP/GAAP Differences

[See table on following page.]

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*[1]
I. RECOGNITION AND MEASUREMENT			
Non-Accrual Loan Status			
Interest Income on loans that are not impaired should be accrued and credited to interest income as it is learned. However, if it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement, the loan is impaired. How and when creditors should recognize, measure, or display interest income on impaired loans is not addressed.	Paragraph 6(g) of FASB Statement No. 118 (FASB, *Current Text*, vol. 1, sec. I08.115).	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The agencies have adopted guidelines that Banks shall not accrue interest on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.	Nonaccrual Status section of Glossary of Form 031 Instructions, Schedule RC of the FFIEC's Consolidated Reports of Condition and Income for Insured Banks with Domestic and Foreign Offices (Reporting Form FFIEC 031).
Valuation of Loans for Nonincurred Credit Losses			
Institutions evaluate certain loans for impairment individually. If a loan is determined to be impaired, the amount of credit loss is calculated as any excess of the recorded loan amount over either the present value of expected cash flows, discounted at the loan's effective interest rate, except as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent.	Paragraphs 8 and 13 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended (FASB, *Current Text*, vol. 1, sec. 108.111).	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The agencies' examiners often have required that institutions record credit losses (based on regulatory classification—50 percent for doubtful, 15 percent for substandard). These recorded losses often go beyond the level necessary to reduce the carrying amount of the loan to its present or fair value, even if the loan is not determined to be impaired under GAAP. Examiners attribute additional amounts to institution specific, rather than loan-specific, factors (such as examiner assessments of the reliability of the institution's cash flow estimates	Loan Impairment section of Glossary of Form 031 Instructions.

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
		and its loan review function and historical loss experience). These judgements are used as analytical tools to justify 'on-top' adjustments, rather than to amend and improve the component assumptions (such as cash flow estimates) used by the institution in estimating the loan's present or fair value.	
		Further, the FDIC requires that when available information confirms that specific loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount), or portions thereof, are uncollectible, these amounts should be promptly charged off against the allowance for loan and lease losses, regardless of whether an allowance was established to recognize impairment under FASB Statement No. 114.	FDIC Transmittal No. 95-051.
Valuation of Impaired, Collateral-Dependent Loans			
Collateral-dependent loans may be valued based on one of the following: (1) the present value of expected future cash flows, discounted at the loan's effective interest rate (2) the loan's observable market price	Paragraph 13 of FASB Statement No. 114 (FASB, *Current Text*, vol. 1, sec. I08.111).	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The agencies require that collateral-dependent loans be valued only based on the fair value of the collateral. The FDIC, OCC, and FRB require that the excess of the loan's carrying value over the collateral's fair value less cost to sell be charged off. The OTS permits institutions to record a specific reserve as alternative to a charge-off.	Loan Impairment section of Glossary of Form 031 Instructions; section 261 of the OTS's *Thrift Activities Regulatory Handbook*.

(Continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
(3) the fair value of the collateral. No specific guidance exists on the timing of charge-offs.			
Foreclosed Assets			
A foreclosed asset to be disposed of by sale must be measured at the lower of its carrying amount or fair value (less cost to sell).	Paragraph 34 of FASB Statement No. 144 (FASB, *Current Text*, vol. 1, sec. D60.111), and FASB Staff Position FAS 144-1, Determination of Cost Basis for Foreclosed Assets under FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, and the Measurement of Cumulative Losses Previously Recognized under Paragraph 37 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.	The OTS Regulatory Handbook, Section 251 states: "OTS policy does not automatically require general valuation allowances on REO. The institution should establish general valuation allowances when it is likely to experience losses when disposing of REO or is likely to incur holding costs that are not reflected in the fair value estimate. The savings association should base the level of any required general valuation allowances on REO on its historical net loss experience, adjusted for current conditions and trends."	None.
Allowance for Loan and Lease Losses			
FASB Statement No. 5 provides the basic guidance for recognition of impairment losses for all receivables (except those receivables specifically addressed by other accounting literature, such as debt securities). FASB Statement No. 114 provides more specific guidance on measurement and disclosure for a subset	Paragraph 8 of FASB Statement No. 5 (FASB, *Current Text*, vol. 1, sec. C59.105); Paragraphs 8 and 13 of FASB Statement No. 114 (FASB, *Current Text*, vol. 1, sec. I08.106, and sec. I08.111.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The Interagency Policy guidance specifies that an adequate allowance for loan and lease losses (ALLL) should be no less than the sum of the following items given facts and circumstances as of the evaluation date (after deduction of all portions of the portfolio classified loss):	Allowance for Loan and Lease Losses section of Glossary of Form 031 Instructions, the *Interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, dated July 6, 2001, and

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
of the population of loans. That subset consists of loans that are identified for evaluation and that are individually deemed to be impaired because it is probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement.		(1) For loans and leases classified substandard or doubtful, whether analyzed and provided for individually or as part of pools, all estimated credit loses over the remaining effective lives of these loans. (2) For components of the loan and lease portfolio that are not classified, all estimated credit losses over the upcoming 12 months. (3) Amounts for estimated losses from transfer risk on international loans. Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses.	the OCC June 1996 booklet, *Allowance for Loan and Lease Losses*
Credit Losses on International Loans			
Valuation allowances (for example, an allowance for credit losses on loans) are related to the assets they value (the loan or group of loans). Additions and deductions from a valuation allowance should not be made for impairments or credit losses of unrelated assets.	None.	Allocated transfer risk reserves (ATRRs) are intended to recognize and measure impairment and credit losses of international assets, which are recognized and measured separately from loans. However, institutions are allowed to recognize and measure in the allowance, credit losses on loan impairments or credit losses on international assets unrelated to those loans.	12 CFR Subparts 28.52(c)(2) and (4).

(Continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
Sales With Minor Leasebacks			
Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. In a sale with a minor leaseback, the seller-lessee relinquishes the right to substantially all of the remaining use of the property sold, retaining only a minor portion of such use. If the amount of the rentals is unreasonable under market conditions at the inception of the lease, an appropriate amount must be deferred or accrued (by adjusting the profit or loss on the sale) and amortized in proportion to the amortization of the leased asset (if a capital lease) or in proportion to the related gross rental charged to expense over the lease term (if an operating lease) to adjust the rentals to a reasonable amount (profit allocation).	Paragraph 33 of FASB Statement No. 13, *Accounting for Leases*, as amended by paragraph 3 of FASB Statement No. 28, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term Initial Direct Costs of Direct Financing Leases* (FASB, *Current Text*, vol. 1, sec. L10.128–129), and issued FASB Staff Position (FSP) 13-1, *Accounting for Rental Costs Incurred during a Construction Period*.	The FDIC requires that the profit allocation in a sale with a minor leaseback must be based on an assumed minimum lease-term of ten years (regardless of the actual minimum lease term). The FDIC allows the actual lease term to be used only if the institution's management has evidence sufficient to confirm that the lease is actually short-term. The FDIC also requires that if the institution finances the transaction (as seller-lessee), the profit recognition must be based on the longer of the note term or the lease term, unless management has evidence sufficient to show that the lease term is actually shorter than that of the note. The other agencies follow GAAP.	Section 3.4 of the FDIC Division of Supervision's *Manual of Examination Policies*.
Income Taxes of Subsidiaries Within a Consolidated Group			
In practice, income taxes generally are allocated to members within a consolidated group in accordance with a tax sharing agreement.	None.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. Each banking subsidiary must be treated as if it were a separate legal entity. An institution is not permitted to receive or make payments to its holding company to the extent the amount differs from the amount owed or due on a separate entity basis.	Taxes (Income) of a Bank Subsidiary of a Holding Company section of Glossary of Form 031 Instructions; Topic 9 (Income Taxes) of the OCC's *Bank Accounting Advisory Series* (June 1994).

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
		If payments are made in excess of that required on a separate entity basis, the institution must record the excess as dividend payments. If payments are less than that required on a separate entity basis, the institution must record the difference as capital contributions. The OTS also requires that a thrift subsidiary be treated no less favorably than if it were on a stand alone basis.	
Acquirer's Accounting Pushed Down to Acquiree's Financial Statements			
Push-down accounting is not required for institutions that do not register with the Securities and Exchange Commission. For SEC registrants, if ownership of an institution changes by 95 percent or more, the acquired institution must use the acquiring institution's basis of accounting in preparing the acquired institution's financial statements (push-down accounting). A change in control means that a person, company or control group obtains ownership in a transaction or planned series of transactions.	SEC SAB No. 54, *Application of Push Down Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase* [codified by SAB No. 103, *Update and Codification of Staff Accounting Bulletins* (Codification of Staff Accounting Bulletins, Topic 5(J): *Push Down Basis of Accounting Required in Certain Limited Circumstances*)]; EITF Issue No. 86-9, *IRC Section 338 on Push-Down Accounting*.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. OTS literature requires push-down accounting when there is at least a 90 percent change in control of all entities, whether or not they are public companies. However, for public companies and in certain other circumstances, the OTS's practice is to require push-down accounting when there is a change in ownership of 95 percent or more. The OTS does not limit its definition of a change of control to a single buyer or control group taking ownership, but includes a change of ownership to a large group of individual buyers acting independently.	Appendix A of the OTS's Service Corporation Handbook.
		The other agencies require push-down accounting for all entities, public or private, when there is at least a change in ownership of 95 percent or more.	Business Combinations section of Glossary of Form 031 Instructions.

(Continued)

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
Related Party Transactions			
Transfers of nonmonetary assets to a stockholder (such as dividends in-kind) must be recorded at fair value; however, that accounting does not apply to transfers of nonmonetary assets solely between companies or persons under common control. Rather, such transfers are accounted for at historical cost.	Paragraphs 4 and 18 of APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (FASB, *Current Text*, vol. 1, sec. N35.105), and FASB Statement No. 153, *Exchanges of Nonmonetary Assets*, an amendment of APB Opinion No. 29.	The agencies believe that this guidance falls within the range of acceptable practice under GAAP. The FDIC maintains that transfers of assets other than cash (for example, securities of another company or real estate) to a stockholder or related party must be recorded at their fair value at the declaration date of the dividend, as if the transfer were completed at arm's length. However, this accounting is governed by the facts and circumstances of the transaction and there are often exceptions to this policy. The OTS and the OCC follow GAAP.	Dividends section of Glossary of Form 031 Instructions.
Institutions must disclose the aggregate amount of loans to directors, officers, employees, and stockholders, as well as to entities with which directors, officers, employees, and stockholders are affiliated.	General guidance on related party disclosures is established in FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, sec. R36.101).	Institutions must disclose extensions of credit to executive officers, directors, principal shareholders, and their related interests.	Schedule RC-M and related instructions to Form 031 Instructions.

II. DISPLAY

Accounting Changes			
New GAAP pronouncements specify how institutions must report accounting changes needed to conform to the new requirements. Some new pronouncements require or allow retroactive application.	FASB Statement No 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*.	Call Report and TFR covers a single discrete period, which prohibits the restatement of prior year's Call Report. As a result, the agencies require that the effect (on undivided profits) of required retroactive application of a new pronouncement be excluded from net income and reported as a direct adjustment to equity capital.	Accounting Changes section of Glossary of Form 031 Instructions.

Generally Accepted Accounting Principles (GAAP)		Regulatory Accounting Practices (RAP)	
Description	*References*	*Description*	*References*
Gain/Loss on Certain Sales			
SEC registrants are required to include in *noninterest expense* the net cost of foreclosed real estate, including gains, losses, and rental income. In practice, classification by nonregistrants of gains and losses on sales of loans, real estate owned, fixed assets (including branch office assets), and other assets varies.	Article 9.04.14(d) of SEC Regulation S-X.	The agencies require that institutions always include rental income in noninterest income. Banks to consistently report net gains (losses) on the sale of certain assets as either other noninterest income or as other noninterest expense.	Line 5(f)(2) and 7(c) on Schedule RI and related instructions of Form 031 instructions.

1 This column does not include references to requirements that conform with GAAP. Only those requirements that depart from GAAP are referenced.

Appendix C

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

Information Sources

Organization	***General Information***	***Fax Services***	***World Wide Web***	***Recorded Announcements***
American Bankers Association	1120 Connecticut Ave., NW Washington, DC 20036 (202) 663-5000		www.aba.com	
America's Community Bankers	900 19th Street, NW, Ste. 400 Washington, DC 20006 (202) 857-3100		www.acbankers.org	
American Institute of Certified Public Accountants	*Member Service Center* 220 Leigh Farm Road Durham, NC 27707 (888) 777- 7077 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (888) 777-7077 or (888) 247-3277	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org www.cpa2biz.com	
Conference of State Bank Supervisors	1155 Connecticut Ave., NW Washington, DC 20036 (202) 296-2840		www.csbs.org	

Organization	***General Information***	***Fax Services***	***World Wide Web***	***Recorded Announcements***
Credit Union National Association	601 Pennsylvania Ave., NW South Building Washington, DC 20004-2601 (202) 638-5777		www.cuna.org	
Federal Deposit Insurance Corporation	*Public Information Center* 801 17th Street, NW Room 100 Washington, DC 20434 (800) 276-6003 (202) 416-6940	*Facsimile Bulletin Board System* (804) 642-0003/2036	www.fdic.gov	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Dept. of Commerce* STAT-USA/FAX. Some information is available to guest users. Other information requires a subscription fee (202) 482-0005	www.frb.gov	*Federal Reserve Board Highlights* (202) 452-3206
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3110 (703) 903-2000		www.freddiemac.com	
Financial Accounting Standards Board	*Order Department* PO Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)

Organization	***General Information***	***Fax Services***	***World Wide Web***	***Recorded Announcements***
Financial Managers Society	100 West Monroe Suite 810 Chicago, IL 60603 (312) 578-1300		www.fmsinc.org	
Independent Community Bankers of America	One Thomas Circle, NW Suite 400 Washington, DC 20005-5802 (800) 422-8439 (202) 659- 9216		www.icba.org	
Mortgage Bankers Association of America	1919 Pennsylvania Avenue, NW Washington, DC 20006-3438 (202) 557-2752		www.mbaa.org	
National Association of Federal Credit Union	3138 10th Street North Arlington, VA 22201-2149 (800) 336-4644 (703) 552-4770		www.nafcunet.org	
National Association of Insurance Commissioners	2301 McGee Street Suite 800 Kansas City, MO 64108-2662 (816) 842-3600		www.naic.org	

Organization	***General Information***	***Fax Services***	***World Wide Web***	***Recorded Announcements***
National Association of Real Estate Investment Trusts	1875 Eye Street, NW Washington, DC 20006 (202) 739-9400		www.nareit.com	
National Automated Clearing House Association	13665 Dulles Technology Drive Suite 300 Herndon, VA 20171 (703) 561-1100		www.nacha.org	
National Credit Union Administration	1775 Duke Street Alexandria, VA 22314 (703) 518-6300		www.ncua.gov	Newsline (800) 755-1030 (703) 518- 6339
Public Company Accounting Oversight Board	1666 K Street, NW Washington, DC 20006 (202) 207-9100		www.pcaobus.org	
Securities Industry Association	120 Broadway, 35th Fl New York, NY 10271-0080 (212) 608-1500		www.sia.com	
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Communications Division* Washington, DC 20219 (202) 874- 4700		www.occ.treas.gov	

Organization	***General Information***	***Fax Services***	***World Wide Web***	***Recorded Announcements***
U.S. Department of the Treasury—Office of Thrift Supervision	1700 G Street, NW Washington, DC 20552 (202) 906-6000		www.ots.treas.gov	
U.S. Department of Education	Washington, DC 20202 (800) USA-LEARN		www.ed.gov	
U.S. General Accounting Office	441 G Street, NW Washington, DC 20548 (202) 512-4800		www.gao.gov	
U.S. Government Printing Office	*Superintendent of Documents* U.S. Government Printing Office P O Box 371954 Pittsburgh, PA 15250 (202) 512-1800		www.access.gpo.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 SEC Public Reference Room (202) 942-8078	*Information Line* (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	*Information Line* (202) 942-8090 (202) 942-8092 (tty)

Appendix D

Major Existing Differences Between AICPA Standards and PCAOB Standards

As the time of this writing, the following major differences existed between AICPA standards and final PCAOB standards approved by the SEC:

- **Risk Assessment Standards.** In March 2006, the ASB issued eight Statements on Auditing Standards (SASs), No. 104–No. 111, collectively referred to as the risk assessment standards. These standards are applicable to nonissuers and are effective for audits of financial statements for periods beginning on or after December 15, 2006. These standards provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. SAS Nos. 104–111 make significant changes to numerous AU sections in the auditing literature. These standards have not been adopted by the PCAOB.
- **Audit of Internal Control.** In connection with the requirement of Section 404(b) of the Sarbanes-Oxley Act that an issuer's independent auditor attest to and report on management's assessment of the effectiveness of internal control, PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, establishes requirements and provides direction that apply when an auditor is engaged to audit the internal control over financial reporting and to perform that audit in conjunction with the audit of an issuer's financial statements. PCAOB conforming amendments related to PCAOB Auditing Standard No. 2 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in Audit* and AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. Note that SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), issued in May 2006, superseded SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325A).
- **Independence Matters.** Rule 3600T requires compliance with Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2 of the Independence Standards Board. Also, to the extent that a provision of the SEC's independence rules or policies are more restrictive—or less restrictive—than the PCAOB's interim independence standards, a registered public accounting firm shall comply with the more restrictive requirement.
- **Independence Matters.** The PCAOB has adopted ethics and independence rules concerning independence, tax services, and

contingent fees. See PCAOB Rules 3501, 3502, 3520, 3521, 3522, 3523, and 3524.

- **Concurring Partner.** Rule 3400T requires the establishment of policies and procedures for a concurring review (generally the SECPS membership rule).
- **Communication of Firm Policy.** Rule 3400T requires registered firms to communicate through a written statement to all professional firm personnel the broad principles that influence the firm's quality control and operating policies and procedures on, at a minimum, matters that relate to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional firm personnel periodically that compliance with those principles is mandatory (generally the SECPS membership rule).
- **Affiliated Firms.** Rule 3400T requires registered firms that are part of an international association to seek adoption of policies and procedures by the international organization or individual foreign associated firms consistent with PCAOB standards.
- **Partner Rotation.** Rule 3600T requires compliance with the SEC's independence rules which include partner rotation.
- **Continuing Professional Education (CPE) Requirements.** Rule 3400T requires registered accounting firms to ensure that all of their professionals participate in at least 20 hours of qualifying CPE every year (generally the SECPS membership rule).

Please note that in the time since publication, these differences might have been eliminated and others might have arisen.

Appendix E

Comparison of Key Provisions of the Audit Risk Standards to Previous Standards

This appendix discusses the key provisions of each of the audit risk SASs and provides a summary of how each of the SASs differs, if at all, from the previous AICPA generally accepted audit standards.

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of *reasonable assurance*.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risks of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • SAS No. 105 emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter.*

SAS No. 106, *Audit Evidence*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence,* defined in SAS No. 106, replaces the term *sufficient, competent evidence.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risks of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditors opinion on the financial statements.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels. • SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risks of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditors opinion on the financial statements.
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

Key Provisions	*How the SAS Differs From Previous Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SAS No. 107 states that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risk of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, you can no longer "default" to maximum control risk.

Key Provisions	*How the SAS Differs From Previous Standards*
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditors responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

Key Provisions	*How the SAS Differs From Previous Standards*
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the client. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should establish a written understanding with your client regarding the services to be performed for each engagement.

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risks of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar to (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risks of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditors assessment of risk.

(continued)

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 states the auditor should assess the risks of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entitys controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditors opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks. • Significant risks exist on most engagements.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risks of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risks of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement assertions, so you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risks of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risks of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risks of material misstatements. — Agreeing the financial statements, including their accompanying notes, to the underlying accounting records — Examining material journal entries and other adjustments made during the course of preparing the financial statements

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

Key Provisions	*How the SAS Differs From Previous Standards*
• SAS No. 111 provides guidance relating to the auditors judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • Ordinarily sample sizes for nonstatistical samples are comparable to sample sizes for an efficient and effectively designed statistical sample with the same sampling parameters.

Appendix F

Schedule of Changes Made to Deposit and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies

As of May 2007

This schedule of changes lists areas in the text and footnotes of the *Depository and Lending Institutions* Audit and Accounting Guide that have been changed from the previous edition. Entries in the following table reflect current numbering, lettering, and character designations that resulted from the renumbering/reordering that occurred in the updating of this Guide.

General	Removed dual references to the AICPA *Professional Standards* literature and the AICPA *PCAOB Standards and Related Rules* literature.
General	Updated; revised to reflect the issuance of SAS Nos. 104-111, the "risk assessment standards". This guide has been conformed to the new risk assessment standards to indicate, at a minimum, where these standards need to be applied.
Notice to Readers	Updated; footnote * added.
Preface	Revised to reflect SAS Nos. 104-111, the "risk assessment standards". Revised to reflect references to Professional Standards. Revised to reflect revisions to filing deadlines for issuers; foonote † added.
Paragraph 1.06	Revised for clarification.
Paragraph 1.20	Added to reflect the issuance of FFIEC and related agency examination manual.
Footnote 1 in heading before paragraph 1.24	Revised to reflect issuance of Tier One Capital Requirements.
Footnote 4 in paragraph 1.26	Revised to reflect federal agencies Notice for Proposed Rulemaking (NPR).
Paragraph 1.30	Added to reflect the issuance of OTS proposed amendment to section 12 of the Code of Federal Regulations 563.81.
Paragraph 1.33	Added to reflect the issuance of federal agencies NFP on risk based capital standards; footnote 7 added.
Paragraph 1.40	Revised for clarification.

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Paragraph 1.72	Revised to reflect the issuance of FDIC, OCC, OTS, and FRB Notice for Proposed Rulemaking on risk based capital requirements.
Paragraph 1.73	Added to reflect the issuance of BASEL II.
Paragraph 2.18	Revised for the passage of time.
Paragraph 2.60	Added to reflect the issuance of NCUA amendment to section 12 of CFR rule 712.
Footnote 1 in paragraph 4.14 and paragraph 4.16 and paragraph 4.17	Revised to reflect the issuance of FASB Statement No. 155, as well as FASB Statement No. 156; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Paragraph 5.43	Revised for clarification.
Footnote † in paragraph 5.66	Revised.
Paragraph 5.67 and paragraph 5.68	Added to reflect the issuance of PCAOB Auditing Standard No. 4.
Paragraph 5.80	Added to reflect the issuance of SAS No. 114.
Paragraph 5.81 and paragraph 5.82 and paragraph 5.83 and paragraph 5.84	Added to reflect the issuance of SAS No. 112.
Footnote ‡ in paragraph 5.84	Revised.
Paragraph 5.110	Revised to reflect the issuance of SAS No. 103.
Paragraph 5.117	Revised for clarification.
Footnote # in heading before paragraph 5.118	Added.
Paragraph 5.161 and paragraph 5.162	Added to reflect the issuance of SAS No. 113.
Former footnote 26 in paragraph 5.226	Deleted to reflect the issuance of FFIEC advisory *Advisory on the Unsafe and Unsound Use of Limitation of Liability in External Audit Engagements*.
Paragraph 5.227	Added to reflect the issuance of FFIEC advisory *Advisory on the Unsafe and Unsound Use of Limitation of Liability in External Audit Engagements*.
Former footnote † in paragraph 6.19 and paragraph 6.20 and paragraph 6.21	Deleted; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Former footnote ‡ in heading above paragraph 6.30	Deleted.

Former footnote ‡ in paragraph 7.75 and paragraph 7.76 and paragraph 7.77	Deleted; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Footnote 5 in paragraph 8.72 and paragraph 8.73 and paragraph 8.74	Revised to reflect the issuance of FASB Statement No. 155 and FASB Statement No. 156; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Footnote 14 in paragraph 8.107	Revised for the passage of time.
Footnote in paragraph 10.17	Added.
Footnote # in paragraph 10.21	Revised.
Former footnote ‡ in paragraph 10.21	Deleted.
Paragraph 10.25	Revised to reflect the issuance of FASB Statement No. 156; former footnote deleted.
10.27	Added to reflect the issuance of FASB Statement No. 156.
Former footnote # in and paragraph 10.28 and paragraph 10.29	Deleted; revised to reflect the issuance of FASB Statement No. 156.
Paragraph 10.34	Revised for clarification.
Paragraph 10.34	Revised for the issuance ofSOP 06-1; footnote 7 deleted.
Paragraph 10.42 and paragraph 10.43	Revised to reflect the issuance of FASB Statement No. 156.
Footnote |||| in paragraph 10.49	Added.
Paragraph 11.08	Added to reflect the issuance of interagency guidance titled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices".
Former footnote † in paragraph 11.10	Deleted.
Paragraph 11.11	Added to reflect the issuance of FASB Statement No. 156.
Former footnote † in paragraph 12.01	Deleted.
Footnote † in paragraph 12.01	Added.

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Footnote 5 in paragraph 12.15	Revised for clarification.
Former footnote 8 to heading before paragraph 12.20	Deleted.
Paragraph 12.20	Added to reflect the issuance of guidance from the Federal Home Loan Bank (FHLB)
Former footnote 15 in paragraph 12.39	Deleted to reflect the issuance of FASB Interpretation No. 47.
Paragraph 12.40	Added to reflect the issuance of FASB Interpretation No. 47.
Footnote ‡ in paragraph 12.61	Added.
Footnote ‡ in paragraph 13.42	Revised.
Paragraph 13.43	Added to reflect the issuance of FASB Statement No. 155.
Paragraph 13.44	Added to reflect the issuance of FASB Statement No. 156.
Footnote 5 in paragraph 13.50	Revised to reflect the issuance of PCAOB Auditing Standard No. 2.
Footnote 6 in paragraph 14.23 and paragraph 14.24 and paragraph 14.25	Revised to reflect the issuance of FASB Statement No. 155 and FASB Statement No. 156; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Paragraph 14.33	Revised to reflect the issuance of FASB Statement No. 156; footnote † deleted.
Former footnote 2 in paragraph 15.19 and paragraph 15.20	Deleted to reflect the issuance of FASB Staff Positions FASB No 45-2 and FASB No. 45-3; added to reflect the issuance of FASB Staff Positions FSP FASB No. 45-2, and FIN 45-3.
Paragraph 15.34	Added to reflect the issuance of SOP 01-6; footnote revised for clarification; former footnote 3 deleted.
Paragraph 15.35	Added to reflect the issuance of FASB Statement No. 155.
Paragraph 15.36	Added to reflect the issuance of FASB Statement No. 156.
Former footnote † in paragraph 16.11	Deleted.
Footnote † in paragraph 16.11	Added.

Paragraph 16.21 and footnote ‡ in paragraph 16.21 and paragraph 16.22	Added to reflect the issuance of FASB Interpretation No. 48.
Footnote 15 in paragraph 17.25	Revised for clarification.
Footnote || in paragraph 17.74	Revised.
Former footnote † in paragraph 18.67 and footnote † in paragraph 18.67 and paragraph 18.68 and paragraph 18.69	Deleted; added; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Former footnote 3 in paragraph 18.71 and paragraph 18.72	Deleted to reflect the issuance of FASB Statement No. 126; added to reflect the issuance of FASB Statement No. 126.
Footnote 3 in paragraph 18.74	Revised for the passage of time.
Footnote ‡ in heading before paragraph 18.79	Deleted.
Footnote * in heading before 19.01	Revised.
Footnote 1 in paragraph 19.04 and paragraph 19.05 and paragraph 19.06	Deleted to reflect the issuance of FASB Statement No. 155 and FASB Statement No. 156; added to reflect the issuance of FASB Statement No. 155; added to reflect the issuance of FASB Statement No. 156.
Footnote † in paragraph 19.08	Revised.
Paragraph 19.17	Revised for clarification; footnote 6 deleted.
Footnote * in paragraph 20.01 and footnote 2 in paragraph 20.01	Revised; revised to reflect the issuance of PCAOB Auditing Standard No. 2.
Footnote 9 in paragraph 20.25 and footnote ‡ in paragraph 20.25 and paragraph 20.26 and paragraph 20.27	Revised to reflect the issuance of FASB Statement No. 155 and FASB Statement No. 156; deleted; added to reflect the issuance of FASB Statement No. 155; Added to reflect the issuance of FASB Statement No. 156.
Footnote * in heading before paragraph 21.01	Revised.

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Former footnote 2 in heading above paragraph 21.16 and paragraph 21.17 and paragraph 21.18	Deleted to reflect the issuance of SOP 05-1; added to reflect the issuance of SOP 05-1.
Footnote 2 in paragraph 21.20	Revised for the passage of time.
Former footnote †in paragraph 21.20	Deleted.
Footnote † in paragraph 21.20	Added.
Footnote * in heading before 22.01	Revised.
Footnote 8 in paragraph 22.18 and paragraph 22.19	Deleted to reflect the issuance of SAS No. 112; added to reflect the issuance of SAS No. 112.
Former appendix D	Deleted.
Appendix D	Added to reflect the differences between AICPA Standards and PCAOB Standards; subsequent appendices renumbered.
Appendix E	Added to reflect the issuance of Risk Assessment Standards.

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